TAX TREATMENT OF LIFE INSURANCE

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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TAX TREATMENT OF LIFE INSURANCE

TUESDAY, MAY 10, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10:12 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

[The press release announcing the hearings follows:]

[Press release of Friday, Apr. 8, 1983]

The Honorable Fortney H. (Pete) Stark, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on the Taxation of Life Insurance

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced hearings on the taxation of life insurance to be held on Tuesday and Wednesday, May 10 and 11, 1983, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. Testimony will be received from the Department of the Treasury, representatives of the life insurance industry, and other public witnesses.

I. HISTORICAL BACKGROUND

Historically, Federal tax laws have permitted a tax-free accumulation of amounts necessary to fund an ordinary life policy on a level premium basis. Companies have been allowed deductions for increases in reserves, and, on the products side, policyholders have not been taxed on increases in cash values. Distributions of cash value on a surrender of a policy have been subject to income tax but death benefits have not been. Annuity contracts have also been permitted tax-free accumulation, but these benefits are taxable when distributed. The Federal income taxation of life insurance companies has followed one of two major patterns since 1921, the free investment income approach and the combined investment income-underwriting income (total income) approach. Under the 1921 Revenue Act, life insurance companies were taxed only on their net investment income. Investment income was reduced by certain deductions, most significantly, a deduction for additions to reserves set aside for policyholders. Investment income after deducting amounts set aside for policyholders was generally referred to as free investment income. There was no tax on the gain from underwriting operations (premium income).

After a series of temporary stopgap formulae (1949-57), Congress adopted a structure of income taxation in 1959 that combined the investment income tax base method with a tax on income from underwriting. The 1959 Act established a two-phase tax computation including a taxable investment income phase and a total income, or combined investment income-underwriting income phase. The 1959 Act also provided significant income tax deferrals on certain gain from operations income and other special deductions peculiar to insurance operations.

The Tax Equity and Fiscal Responsibility Act of 1982 (PL 97-248) made several important changes in the taxation of life insurance companies. Most of these changes are effective for a two-year stopgap period which will expire at the end of

1983, pending a comprehensive review of Subchapter L of the Internal Revenue Code. See Subcommittee Press Release #1 (January 27, 1983).

In recent years, the administration of the tax system and the development of modern life insurance products have taken divergent paths with undesirable results for all concerned. For example, tax-free inside buildup historically permitted in life insurance products has led to the creation of products which emphasize the tax-shelter aspects of life insurance to the detriment not only of the Treasury but also of other parties competing for the savings or investment dollar. At the same time, life insurance companies have encountered significant problems in qualifying their products as life insurance for tax pruposes or in maintaining their life insurance company status as they moved into new fields of business. Similarly, because provisions in the Life Insurance Company Income Tax Act of 1959 were premised on the belief that interest rates would not accelerate at the rate they have recently, neither the Treasury nor the industry has confidence that the 1959 Act is continuing to function well. Thus, the Subcommittee believes that a complete reexamination of the taxation of life insurance companies and their products is warranted.

II. FRAMEWORK FOR DISCUSSION

As a policy goal, the Subcommittee hopes to develop a statutory approach that would be less complex than the present tax structure and yet would reflect the individual purpose and character of life insurance transactions. Any new structure for taxing life insurance companies and their products should meet the needs of the modern insurance industry by allowing it to compete with the aggressive investment management of other financial intermediaries while at the same time placing a reasonable limit on the tax-sheltered nature of the products it markets.

The Subcommittee invites testimony on the following specific questions:

General policy issues

After identifying the various components of a life insurance transaction, how might the tax system best reflect these transactions?

How much tax incentive, if any, should be associated with life insurance to assist the public in purchasing adequate protection?

Are the various financial intermediaries who compete for investment and savings dollars able to do so on equal terms?

Policyholder taxation

What is the historic or social justification for allowing the policyholders to receive tax deferral on the inside buildup in a policy?

To what extent should various types of life insurance products continue to enjoy tax preferred treatment as compared to other savings and investment products available to individuals?

To achieve comparability with other investments available to individuals, what would be an appropriate limit on the tax-deferred element of a life insurance investment?

Should limitations be placed on the amounts that may be invested in the tax-preferred life insurance contracts?

If limitations are placed on the amount of deferral available to policyholders, should any resulting tax be imposed at the policyholder or the company level?

What are the emerging trends in the industry with regard to unbundling of the investment component of life insurance policies?

Taxation of life insurance companies

How can the present three-phase system of taxing life insurance companies be simplified?

Should taxation of investment income and taxation of underwriting income be combined in a total income approach?

If companies are taxed under a system which segregates investment and underwriting income, what level of policyholder dividend deductions, paid out of underwiting gains, would be appropriate?

Given the current general industry practice of currently using a preliminary term method for calculating reserves, can the provision for revaluing to net level reserves be eliminated?

If revaluation of reserves to net level reserves is retained, how should the problems presented by graded premium products be addressed?

What is the justification for special deductions for contingency reserves for nonparticipating contracts, group life, and health and accident contracts? Are they still necessary?

Should deductions for excess interest and premium adjustments be subject to the same limitations applicable to policyholder dividends?

What is the most appropriate way to reflect the equity-ownership element in policyholder dividends?

Should the definition of a life insurance company be revised to reflect changes in the product mix offered by the companies?

How should qualified pension business be treated for tax purposes to ensure competitive neutrality with uninsured pension plans?

What is the justification for any special provisions for small life insurance companies? If there is a justification, what is the appropriate definition of a "small life insurance company"?

How can Congress continue to assure that reinsurance transactions are not used by the industry to avoid tax liability?

What mechanism, if any, should be used to assure that all insurance companies pay their minimum share of taxes? How would such a minimum tax be structured?

Transition issues

If the phase system is eliminated, how should the existing "overhang" of deferred income be treated? Should there be recognition over an appropriate spread period?

In the event of major structural changes in the tax treatment of life insurance companies and their products, what transition problems are presented with respect to existing products?

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler ((202) 225-3627) no later than the close of business, Friday, May 6, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Any requests to be heard received after that date will not be accepted. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee must comply with the following rules:

1. All witnesses must submit 40 copies of their prepared statement to the full Committee office, Room 1102 Longworth House Office Building, not later than the close of business, Friday, May 6, 1983.
2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.
3. Not more than five minutes will be allowed for the oral summary.

The Subcommittee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515, by close of business, May 25, 1983. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing.

Chairman STARK. If our guests would be seated, the subcommittee will begin. We are going to begin 2 days of hearings on the issue of tax treatment of life insurance companies. For the last 24 years, these companies have been taxed under the 1959 act.

The Tax Equity and Fiscal Responsibility Act of 1982 made several important changes to the provisions governing the taxation of life insurance companies. These changes were intended as temporary measures pending a review of the 1959 act.

Over the past several months, this subcommittee has held many meetings with the Ways and Means Committee staff, the joint committee, the staff of the Treasury, the Treasury Department officials, leaders in industry and their representatives. I want to commend all of the staffs of the various groups, including the minority staff, for their patience and their arduous work in preparing not only themselves, but, most difficult of all, preparing the Chair and various members of the committee, for the task of understanding the complexities involved in this industry.

I also want to thank many members of the industry and their counsel for providing information to us, for volunteering to work with us and answer our questions, and to suggest to those who did not avail themselves of the very wide-open door that existed in the offices of members of the committee and the staff for the past several months that they now avail themselves of that opportunity. I say this because I am sure, as the testimony will show as it unfolds over the next several days, there are many who have been misinformed about the intention of the committee and the work of the staff.

From the beginning, our concern has not been, as some may believe to raise a specific amount of revenue or to favor one type of insurance protection or one type of company over another, our intention has been to find a structure and define a structure through which the true economic income of life insurance companies may be taxed in a manner that is fair, comprehensible, and preserves the basic framework of the industry and their traditional products.

The 1959 act adopted a total income concept as the general approach, and earnings from investments, as well as gains or losses from underwriting, were included in taxable income. Almost everyone agrees that this income approach was clearly the correct result.

However, as you analyze the act, you soon realize that this basic approach is implemented through a series of provisions that are complicated and, more importantly, severely distort the very tax base which the 1959 act was intended to apply. Unraveling the complexities is not easy.

The industry is pretty much evenly divided between stock and mutual companies, and in an attempt to strike a competitive balance, as well as to raise a predetermined amount of revenue, the 1959 act created a series of deferrals, deductions, and revaluations that run through the income like calculations a pachinco ball coming down the board. There is little rhyme or reason to the interrelationship between the various deductions, deferrals and revaluations.

Having said all this, the system did function until in recent years, high interest rates upset some of the more ingeniously crafted mechanisms in that act. At the same time, these high interest rates produced dramatic increases in taxable income and motivated some members of the industry to devise self-help tax reduction methods in the form of Modco transactions. In addition, life insurance companies began to compete in a world in which consumers became far more sophisticated and distinctions between financial intermediaries began to blur.

It has often been suggested that, if something is not broke, why do we fix it? Certainly that has been a question that many of the members of this subcommittee have raised. I think it is interesting to note that we are assembled here today basically as a result of intense lobbying on the part of both the stock and mutual companies. To my knowledge, no Member of Congress has approached the Chair or the Chair of the full committee and suggested that it was high time we reviewed taxes on life insurance.

But we accept the challenge and the responsibility happily, but I think it is important to note that there really are some things broke, and we would like to work together with you to fix them.

During consideration of the Tax Equity and Fiscal Responsibility Act last year, Congress repealed Modco, but made most of the other TEFRA changes temporary to give us time to prepare a suitable replacement for the 1959 act. And it is that charge which we officially begin today.

In an attempt to form a theoretical approach, we have considered a wide range of options and I want to make it clear that there has been no bill drafted, nor any single approach or theory embraced, as some have alleged. We do not intend, as I said earlier, to raise a predetermined amount of revenues, nor do we plan to tax policyholders. It has even been suggested that we plan to tax health benefits. Such statements are naive and incorrect.

It has always been our goal to develop a corporate-level tax using a total income approach. But we have suggested that, where a particular deduction or income tax benefit accrues to a policyholder or to a company, we would prefer that there be some rationale for that, and I would suggest to the industry that staff and the members of the committee have looked for ways to help the industry establish that rationale.

The Chair has a sincere intention to work with all of the members of the committee in a bipartisan manner, and, hopefully, with the help and cooperation of the administration and all segments of the industry, to fashion permanent legislation which is equitable and understandable.

To the extent political accommodations are necessary and will be necessary, they should be made, in the opinion of the Chair, in a manner consistent with sound tax policy and after a structure has been developed.

It is my belief that we can complete this task before the expiration of stopgap at the end of this year. If this, however, is beyond our political or intellectual reach, I would like no one to be under the illusion that stopgap will be simply extended. Such an extension should be accomplished with a significant toll charge.

Unfortunately, an extension of stopgap would also leave the industry in a position of uncertainty, both as to some of its products that it sells and the long-range level of tax it must pay. So we look forward to the industry cooperating with us.

With several exceptions pointed at both the two major segments of the industry, the mutual companies and the stock companies, and with the very distinguished exception of the administration, represented here by the Honorable John Chapoton, Assistant Secretary for Tax Policy, and one or two other exceptions during the next several days, the Chair is going to adhere to the 5-minute rule for witnesses. And we have, happily, received testimony in advance from all of you.

The Chair will encourage members to question the witnesses as long as they wish. It is not the Chair's intention to limit witnesses' opportunity to inform and educate the committee. But we can all read silently far faster than any of us can read aloud, and it will give everybody more opportunity to exchange ideas with the committee if you will allow us to be fairly strict on the time limit.

At this time I would like to yield to our distinguished ranking minority member from Tennessee, Mr. Duncan, for a statement. John.

Mr. DUNCAN. Thank you, Mr. Chairman.

The hearings we are holding over the next 2 days are very important for several reasons. Their outcome will affect the taxation of over 2,000 life insurance companies employing many individuals throughout our 50 States. In addition, the outcome may impact the more than 150 million policyholders throughout the country.

The far-reaching impact is further highlighted when one realizes that over 80 percent of all households are covered by some form of life insurance, and the important role that life insurance plays in our economy also cannot be underestimated by our committee. Life insurance companies hold over $525 billion of assets and certainly represent an important source of capital for numerous sectors of the economy.

The history of taxation of life insurance companies, which is set forth in the pamphlet prepared for the hearing, indicates the taxation has gone through a number of different phases, with the most recent changes occurring as a result of the Tax Equity and Fiscal Responsibility Act of 1982. Prior to that, the 1959 act had controlled taxation of the industry for many years.

In the past, the Ways and Means Committee and the Congress in general played no important role in the development of the method for taxing the industry. As a result of Mr. Stark's leadership, a significant effort has certainly been made to make the committee aware of the important issues which are presented in developing any method for taxing life insurance companies.

But in developing a new and permanent structure for the taxing of the industry, there are several important factors which we as a committee should be appreciating. First, we should recognize that the competitive balance in the industry between the various sectors of the industry must be maintained.

Second, we should recognize that many small companies have unique problems which deserve careful attention in developing any permanent structure of taxation.

Third, I think we should be careful that the legislation does not unduly inhibit the ability of the life insurance industry to continue to serve the important social goals which it has served for many years. At the same time, I think we must recognize the realities of a changing climate with respect to a whole range of financial intermediaries and the need to maintain the competitive balance among them.

I am, therefore, Mr. Chairman, looking forward to the testimony of the witnesses, and I want to commend you for your initiative in calling the hearings. I am sure that something will evolve that will benefit our country.

Chairman STARK. Thank you very much, John.

Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Chairman, I want to commend you for the outstanding leadership that you have provided the subcommittee in considering this insurance company tax issue. And I also want to thank the tax staff and the joint committee for the help that they have provided me in looking at this.

Mr. Chairman, the insurance industry has experienced substantial growth since 1959. The trend is clear, no matter which measure is utilized. The industry has prospered and grown at a rate far in excess of the overall growth of the national economy.

Over the past two decades, the assets of life insurance companies have grown at an average annual rate of 7.3 percent, and the income of the industry has experienced a double-digit annual growth rate of 10.7 percent.

Mr. Chairman, the tax burden on the insurance industry cannot be described as overly burdensome. I think the ratio of Federal tax payments to the total income of the industry ranged from 2.3 to 2.6. And I recognize that there are many ways that you can look at that, but describing the tax burden as overly burdensome probably would not be one of the ways to look at it.

The 1959 act has not functioned flawlessly in every respect. The provisions of the 1959 act did not adequately anticipate the impact of double-digit inflation and interest rates, and it did not adequately anticipate the impact of the economic turbulence of the seventies on the perception of the industry's products by consumers or the changes now well under way in the marketplace for financial services.

In my opinion, Mr. Chairman, we still have a long way to go in designing a rational tax structure for the insurance industry. I must express my disappointment with the failure of the industry to provide the subcommittee with some type of unified approach to revising the 1959 act. I think that it would be very helpful for the industry to work together to develop many of these problems, many of these issues, such as the definition of insurance.

Mr. Chairman, as you know, the financial marketplace is undergoing fundamental structure change. The change is apparent every day when we read newspaper reports of banks purchasing insurance companies and insurance companies buying banks, the evolution of department stores into financial supermarkets and the expansion of brokerage houses into virtually every community of reasonable size in the country.

Mr. Chairman, there is no reason to believe that the insurance industry can or would be willing to be isolated from the prevailing trends. There is a genuine and compelling need to work toward a rational tax structure for the industry that will allow the industry to continue to prosper and grow in a competitive environment.

Mr. Chairman, there are other issues that I hope the industry will consider, and I would like to hear more discussion on the role of the insurance industry in fostering savings in our country. The conventional wisdom suggests that the industry perform this function adequately, but the basic fact is that the rate of savings among Americans has remained low and stable over the past few decades, while the industry has enjoyed relatively high growth rates.

The needs of the U.S. economy for capital funds should be enormous over the next two decades, and I hope the expert witnesses scheduled to appear will provide us with their views on how the insurance industry can help meet the growing need for investment funds.

Again, Mr. Chairman, I want to thank you for the leadership that you have demonstrated in preparing these hearings, and the list of witnesses is indeed impressive, both in terms of quality and quantity, and I look forward to participating in the hearings.

Chairman **Stark**. Thank you very much.

Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I just want to say that most of us on the committee have tried to do as much studying and reading on the insurance industry and the tax consequences to that industry as we could in the last several months. I remember reading in graduate school the writings of Adam Smith of a couple of hundred years ago, in which he set out certain maxims of taxation, one of which was that it be fair. Another very important one was that it be easy to understand.

The fact is, this is not very easy to understand. It is a very, very difficult and complex subject. The tax laws as they apply to the insurance industry as a whole is a very complex and difficult set of tax laws to understand. I would hope that as we proceed through these hearings that we could keep an eye on those two goals, fairness and simplicity.

The industry is an important one in this country. It is an industry that, as Congressman Flippo said, is growing. It is becoming more and more complex, and I am hoping that we can thread through all of that and come up with a tax program that is both fair and simple and one that makes sense in the scheme of our entire Internal Revenue Service Code in this country.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you very much.

Mr. Moore.

Mr. **Moore**. Thank you, Mr. Chairman.

Mr. Chairman, I too want to join my colleague from Alabama in initiating any discussion this morning with congratulations to you on the work you have done. You have dug deeply into a complex subject and are to be congratulated for having taken the initiative.

I think by virtue of the fact that you have spent so much time on this we will probably see legislation move forward out of this subcommittee and the full committee revamping to some extent the taxation of life insurance companies.

Mr. Chairman, I fully agree with you that something needs to be done. The stopgap legislation expires at the end of this year and I have not met anybody yet who expects or wants that to take place.

I hope we are going to try, and I think it is the chairman's intent, to create a level playing field between companies, so a tax advantage will not exist between a stock company or a mutual company; or Mr. Chairman, between a life insurance company and any other kind of institution selling a product. Life insurance companies should not be favored over any other type of enterprise operating in our society if they are selling a similar product.

Mr. Chairman, you are also to be congratulated for not just taking a look at the least that can be done, but doing what Congress needs to be doing more of, and that is looking at the entire law, the history of it and all facets of it. I think that those in attendance today should be aware of the fact that there are many of us who share the idea that we ought to look at the entire law and not just at what kind of bandaid we can put over the subject, as has been done too many times in the past by Congress on too many issues.

I think it is possible for us to produce legislation. I think it is unfortunate that the industry at this point is divided and cannot come to us to speak with one voice. But I do not think that is going to deter the committee. If we have to make the decisions, we will just make them.

The amount of revenue to be raised by a tax bill is not my concern. What we are looking for is permanent, equitable legislation dealing with life insurance companies. We are not trying to raise X amount of dollars to fulfil some sort of preconceived notion of how much money life insurance companies ought to pay in taxes.

I should also point out, in fairness again to the chairman, that nothing has been decided, nothing is set in stone, except something has to be done. Hopefully these hearings will help to shape the future bill and a future solution to an existing problem.

As an aside, I say to my good friend from Alabama, the savings rate has been down. However, the initial reports we are getting indicate that the changes we made in 1981 in IRA's and Keogh's are reversing that trend. I think, the Reserve Bank in Atlanta, has noted a possible 2 to 3 percent jump in the savings rate in the year 1982, a bad year for the economy.

In any event, the gentleman is quite right that this is also something we would like to hear from the companies on.

Thank you, Mr. Chairman.

Chairman STARK. Thank you very much, Mr. Moore.

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

I too, Mr. Chairman, would like to thank you very much for not only the time that you yourself have spent on this question, but the time that you gave me as a member of your committee sitting, talking, and explaining what your goals were in looking at this very intricate problem.

The gentleman from North Dakota and I often agree, and I know he hopes he can get an answer to these tax questions that is fair and simple. I doubt this morning that the answer is going to be simple. I do think that in the best traditions of a committee of the U.S. Congress, each and everyone of us that sit on this committee have spent many hours learning this very complex area of the tax code, not only with Mr. Stark but the committee staff. That has been absolutely marvelous.

Two months ago I would not have believed that I would have read as much as I have read about insurance. We have a great deal of information. We have a list of witnesses that are excellent, especially the leadoff witness, Mr. Chapoton.

So we start this morning, and maybe this will be the only time we do have a level playing field, in that we all have the same amount of information. We are all going to start, hopefully, with no preconceived ideas.

I also would like to add another word to "fair" and that would be "compromise." I think the subcommittee's position is that we find the fairest compromise in trying to answer the question of how to tax the insurance industry.

Maybe I will add another word: "tradition"; there is a great deal of tradition in how insurance companies are taxed, and I do not think you can discount tradition. I am sure we will have a great deal of discussion, Mr. Chairman, because we have a large audience here, there is a great deal of interest.

I read last night two of the longest pieces of testimony. Having read them, I found that one-half of the industry was still on one side and one-half still was on the other. Somehow, we might get to the middle.

So I thank you, Mr. Chairman, for all your work and courtesy. I look forward to the discussion, and I know that in the end some people will be happy.

Chairman **Stark**. Thank you very much.

Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

I, too, look forward to these hearings, and recognizing the obvious complexity of the issue, and that those Members of the House who are not members of this subcommittee or members of the full committee will be somewhat dependent upon the experiences that we go through in these hearings.

From our meetings and discussions prior to this hearing, it appears to me that the members of the subcommittee are truly uncommitted. Many of the questions that will be asked of the various witnesses, whether they be large stocks, small stocks, or mutuals or other people, may appear to be somewhat penetrating, but that should not necessarily indicate what a member on the committee may be thinking.

I want to emphasize that, from my own study of the issue, I am not totally convinced that we can come out with a very simple tax structure. Simplicity, as much as it may be desirable, should not be the ultimate aim, if that is impossible from the standpoint of fairness.

I look forward to attending and listening to the various witnesses from the companies. I hope that the companies will recognize that every Member of Congress has his or her constituency made up of policyholders from mutual and stock companies, and, as a result, most of the members of this committee are uncommitted.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you very much.

Mr. Duncan.

Mr. **Duncan**. Mr. Chairman, do you plan to go on through lunchtime?

Chairman **Stark**. It will be the intention of the Chair, if there is no objection, to work straight through the day as rapidly as we can with the understanding that people may have to break from time to time. Without objection, we will continue with the hearings.

It is now my privilege to call on the Honorable John Chapoton, Assistant Secretary for Tax Policy.

Buck, welcome to the committee once again. As I indicated earlier, you are one of those witnesses who we would like to accommodate with some additional time. You may proceed to enlighten us in any manner that you see fit.

Mr. Duncan.

Mr. **Duncan**. Mr. Marriott was listed as the first witness.

Chairman **Stark**. We have arranged for Mr. Marriott to testify at another time.

Mr. **Duncan**. Fine. I just wanted to call your attention to that.

Chairman **Stark**. Thank you.

Buck.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. **Chapoton**. Thank you, Mr. Chairman.

We do, as you point out, have a quite lengthy statement. I will attempt to summarize it, but I think I will take longer than is usually the case.

I am pleased to have the opportunity this morning to present the Treasury Department's views on the taxation of life insurance companies and their policyholders. Life insurance taxation is an important, complicated subject, and it presents many interrelated policy issues.

In determining the proper taxation of life insurance policyholders and companies, it is necessary to understand the economic components of a life insurance policy. All life insurance policies can be divided into two components: a pure insurance component and an investment or savings component.

A pure insurance component involves a redistribution from the policyholders to the beneficiaries of those policyholders who die. The investment component involves the investment of funds paid by the policyholders between the time that they are received by the company and the time they are paid out to the beneficiaries of the policies.

The premium charged by the companies reflect the amount of both the insurance and the investment components. The amount that an insurance company will charge for the insurance component depends on the company's estimate of the probability that the policyholder will die during the period of coverage. This estimate is generally based on the published mortality tables.

The investment component involved in a cash value life insurance contract means the policyholder is paying an additional amount to be held by the company in a fund for his benefit. Some portion of the fund, together with interest credited thereon, may be used to pay the cost of term insurance in some future period, and any balance will be returned to the policyholder if the policy is surrendered, or to his beneficiaries in the form of death benefits if he dies while the policy is in effect.

Thus, a policyholder who pays a premium in excess of the cost of insurance for the current year in which the premium is paid is in effect making a deposit to a savings account. The investment income credited on the savings account is sometimes referred to as the inside buildup under the policy.

The total amount of premiums, plus investment income, held for the benefit of the policyholder at any time, less the total cost of insurance for all prior periods, is referred to as the cash surrender value of the policy at that time.

Traditionally, the investment aspects of a life insurance contract have been secondary to the insurance component. In today's financial marketplace, however, it is no longer the case. All financial intermediaries, including life insurance companies, are in stiff competition for investment dollars; and the investor has become much more sophisticated.

In response to the increased investor sophistication, life insurance companies have been changing their products in a number of ways. First, they will now pay close to a market rate of return to the policyholder even though the minimum rate of return guaranteed in the contract is still fixed well below market.

Second, in many new policies the traditional link between insurance protection and the savings component of a policy has been broken.

Third, a type of insurance now available, known popularly as universal life, allows the policyholder discretion as to the timing and the amount of premiums he pays.

And, finally, certainly modern life insurance contracts allow the policyholder actually to choose the investment to which his money is put during the time it is held by the insurance company.

I think it would be instructive in discussing the relationship between the investment and insurance components of a cash value life insurance policy if we look at a couple of examples; and they are contained in our testimony in tables and charts, and each of the four examples are attached or have been given to each of the members.

The basic assumptions in each of these examples is the individual buying the insurance is 35 years old; the insurance company is guaranteeing a return of 4 percent, and that is the assumed rate on each of these examples. The mortality rates used are based on the 1958 Commissioner's standard ordinary mortality table, and we are assuming no loading charge because it makes the computation more easily understood and does not change the basic principle that we are trying to teach with these examples.

The first example is straightforward whole life, level premium, level death benefit policy of $100,000. Based on these assumptions I just described, the annual level premium for the policy is $1,445. Table 1 shows the allocation of the premiums between the mortality charges and the savings deposit. It also shows the investment income under the policy.

A few general observations are important here. First, while the death benefit provided under the policy remains at a level $100,000, the amount of actual insurance protection that the company must provide at any given time was equal only to the excess of $100,000 over the cash surrender value of the policy at that time.

For example, in this case when the individual reaches age 55, the cash surrender value plus the savings component of the next year's premium is $33,560. You can see this from columns 2, 5 and 7 on table 1. That is, the amount of insurance protection that the company must provide in the following year is equal to $66,440, column 4.

Even though the mortality charge for a fixed amount of insurance—$100,000 in this case—increases steeply as the policyholder grows older, the fact that the amount of insurance protection declines steadily over the life of the policy means that the actual mortality charges under the policy increase much more slowly. This allows the investment income credited to the policyholder to grow constantly, even where the cash value earns interest at the modest rate of 4 percent assumed in this example. In no year of the policy does the mortality charge exceed the sum of the annual premium and the investment income for that year; that is, the cash surrender value of the policy never decreases.

It might also be observed in chart 1 that at all times during the life of the policy the cumulative interest earnings are roughly equivalent to the cumulative mortality charges. This would be true if loading charges were included in the example as well.

Example 2 is a single premium policy under the same assumptions. Based on the assumptions that I have given, the single premium necessary to purchase a policy providing a $100,000 death benefit with endowment at age 99 is $27,600. Because of the large initial deposit, the amount of pure insurance protection which must be provided is significantly less than under a level premium policy. This results in lower mortality charges and a much quicker accumulation of investment income. At all times during the life of this policy the cumulative investment income is more than double the amount of the cumulative mortality charge as shown in chart 2. Thus, examples 1 and 2 illustrate that a single premium policy has a significantly higher investment component and smaller insurance component than a level premium policy providing the same death benefit.

Let me skip to example 4. It involves an increasing death benefit policy. A policy that calls for an increasing death benefit will require higher premiums than one which does not. Paradoxically, a policy that calls for an increasing death benefit is much more highly investment oriented than one which does not, and this is because the increasing death benefit is paid not out of more pure insurance protection but out of investment earnings.

For example, the figures in chart 4 assume a single premium policy for a 35-year-old man with an initial death benefit of $100,000, and that that $100,000 death benefit automatically increases by 3.5 percent annually compounded. The annual interest rate credited under the policy is 4 percent, as in our other examples, and the policy endows at age 99.

The single premium, as you can see, is $84,200. Since the return credited is higher than the rate of increase of the death benefit, and since the mortality charges are so low, the amount of insurance protection never exceeds $21,000 in any year. By the time the policyholder reaches 65, investment income of $196,500 will have been credited while the total cost of insurance coverage is only $6,000.

It might be noted that if the death benefit grew at the same 4 percent as the return credited to the policyholder rather than 3½ percent as we have assumed here, the premium would be $100,000 for a $100,000 policy, and there would be no insurance element whatsoever.

The point of those examples is to give you some feel for the interrelationship of the investment component and the insurance protection of traditional policies, and how the investment component becomes much more significant with single premium policies, and the example I skipped, with endowment policies, and with policies that have increasing death benefit, the investment portion becomes much more significant.

Let me describe very briefly the current law rules applicable in taxation of life insurance policyholders. The first and probably the most important benefit provided the policyholder is that the investment income earned on the policyholder's savings account that I just described is not subject to current taxation. He is not treated as having constructively received income by virtue of an increase in the cash surrender value, even though he has in some cases quite easy access to the funds.

The second benefit is the 101(a) of the Internal Revenue Code which excludes from the gross income of a beneficiary all life insurance proceeds; and this is true even though a part of the proceeds is return of the policyholder's savings deposit and a return of investment earnings.

The important point here is to note that the 101 death benefit exclusion converts the deferral of tax on investment income into a permanent exclusion, and the greater the investment orientation of the policy, the greater the benefit of this exclusion.

A third item is what we refer to as a mismeasurement of policyholder investment. If a policyholder surrenders his life insurance policy, he is taxable as ordinary income on the difference between the amount received on surrender and the amount he has invested, the aggregate gross premiums he has paid on the policy. In effect, his basis is aggregate premiums. No reduction is made in his basis by the fact that a portion of those premiums paid mortality charges—that is, paid current insurance protection—and that that cost would normally be considered a personal expense of the policyholder. It would not normally be an item that would be included in basis of an asset.

Fourth, the ordering of withdrawals is an important element. If a policyholder withdraws sums from his policy, withdrawals are treated as first being made out of the policyholder's investment in the policy, and only after the entire investment has been withdrawn is any amount included in taxable income. For example, in the first example I described the straightforward policy level premium and level death benefit of $100,000, at age 65 the policyholder could withdraw up to $44,800 completely free of tax.

And finally, I will just mention the treatment of policyholder loans. Policyholder loans are respected as loans and are not treated as withdrawals, even if they are not repaid prior to the death of the insured. Moreover, interest paid on a policyholder loan is generally deductible even though the income earned on the policy, which accrues for the benefit of the policyholder, is not subject to current tax.

There are exceptions to the deductibility of the interest which I will not go into now.

I would like to give you just a few of our thoughts on the policy considerations involved in the current tax treatment. The proponents of the favorable tax treatment of the items I have just described of cash value life insurance assert that this treatment serves three significant policy goals.

First, the tax treatment encourages people to purchase life insurance protection for their families. Second, it encourages people to save on a fixed schedule through life insurance. And a third policy consideration advanced is that savings through life insurance companies foster long-term investment. While cash value policies are in force, the amounts saved by the policyholders are combined by the insurance company to form a large block of capital which the insurance company may invest on a long-term basis. This concentration of investment capital historically has allowed insurance companies to play a significant role in the capital formation of this country.

The fact that the tax benefits afforded cash value life insurance are greatest when the investment aspects are highest shows that the policy reasons underlying the current tax system include clearly the encouragement of savings through life insurance policies. Other tax-preferred investments such as qualified pension plans and individual retirement accounts have significant limitations on the timing and amount of contributions, withdrawals, loans and the like. Comparable financial investment of vehicles without these limitations generally do not receive the tax-free or at least tax-deferred status which is afforded to savings through life insurance.

With that background, let me mention three areas of legislative concern in the taxation of policyholders that we think merit the consideration of the subcommittee.

First, a definition of life insurance should be added to the Code to prevent policies which are overly investment-oriented from obtaining the favorable tax benefits that are given to life insurance.

Second, the tax benefits made available to those policies which do qualify as life insurance should be consistent with sound policy objectives.

Third, serious thought should be given to tightening the tax rules relating to surrenders, withdrawals and policyholder loans so that favorable tax benefits given to life insurance are not available where the underlying policy objectives to these benefits are defeated.

Let me go through these thoughts very quickly, Mr. Chairman.

First, on the definition of life insurance, we think that in light of the recent changes in the industry, a definition of life insurance is a necessity. In formulating this definition, a traditional level premium, level death benefit whole life policy could be used as a clear example of a policy which is not overly investment oriented.

From this starting point it is useful to bear in mind how certain features of a life insurance policy affect its investment orientation. In particular, a single premium policy is considerably more investment-oriented than a level premium policy providing the same death benefit, as the examples I went through showed.

Second, the earlier a policy endows, the greater is its investment orientation.

And third, a policy which calls for increasing death benefits is a more highly investment-oriented policy than one which calls for a level death benefit.

Having defined life insurance, it will be necessary to deal with the tax treatment of life insurance policies which fall within the definition and thus are entitled to whatever tax benefits are decided to be appropriate.

We support the continuation of properly structured tax incentives to encourage the purchase of life insurance. Specifically, we support the continued exclusion from gross income of all amounts payable by reason of the death of the insured, even though a portion of death proceeds is attributable to investment income.

It may be appropriate, however, to reconsider whether all investment income under a life insurance policy should continue to be exempt from current tax. When this examination is made, the treatment of investment income will bear an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing a narrower limit on the investment orientation of a life insurance company, there is more reason for allowing favorable tax treatment to the investment income under the policies which fall under a tighter definition.

With regard to surrenders, withdrawals and policyholder loans, we suggest that consideration be given to making three changes.

First, in calculating the policyholder's investment in the life insurance contract, we think that the portion of the aggregate premiums which have been used to pay the cost of current insurance should be subtracted.

Second, we think that the ordering rules regarding the treatment of withdrawals should be reversed. Any withdrawal of cash from a policy should be treated as taxable income to the extent cash surrender value of the policy exceeds the policyholder's investment in the policy.

This new ordering rule was instituted in TEFRA last year for annuity contracts. We would support the corresponding change for life insurance and endowment contracts.

Finally, we believe that some limitation should be placed on policyholder loans. Such limitations we think are necessary to prevent wholesale avoidance of the tax rules regarding surrenders and withdrawals. The rules regarding loans from qualified employer plans contained in section 72(p) of the code, which was added last year by TEFRA, might serve as a guideline for such rules.

We see no reason why loans from life insurance policies should receive more favorable treatment than loans from qualified employer plans.

Let me now turn, Mr. Chairman—I appreciate the complexity of the subject and I know we are going through it rather fast. Let me now turn to the taxation of the company side of the policy.

As has been said by the chairman and several of the members in opening statements, the taxation of life insurance companies are some of the most complex and least logical provisions in the tax law today. The present provisions were adopted in 1959, and we quote I think a very apt statement by Judge Fletcher in our testimony, Judge Fletcher of the U.S. Court of Claims, "These complex and obscure provisions bear all the earmarks of a conspiracy in restraint of understanding."

We share that view. The existing system of taxing life insurance companies is, we think, seriously flawed and in need of major overhaul. Since 1959, economic conditions have led to changes in the way insurance companies operate and in the types of policies they offer.

In addition, life insurance companies compete with other financial intermediaries to an increasing extent. The application of the existing tax rules to these changed economic conditions is no longer satisfactory.

I would like to emphasize at the outset that the Treasury Department is not here today to suggest an appropriate aggregate tax burden of the life insurance industry. Rather, our goal is to work toward replacing the cumbersome and outdated existing system with a statute which is simpler, fairer, and more rational.

Let me make a few general observations at the outset. A unique aspect of the life insurance industry is that its business is conducted in roughly equal portions by stock companies and mutual companies. Stock companies are ordinary corporations that operate in the insurance business. They are owned by their stockholders and their policyholders are their customers. The legal obligation of mutual companies is different in that they do not have a separate class of stockholders. The owners of a mutual company are also its customers.

Both types of companies sell a large volume of cash value life insurance, discussed earlier. This type of insurance includes two components, the savings component and the pure insurance protection component. Hence, in issuing a life insurance policy a life insurance company serves two roles: first, it operates as a financial intermediary in that it borrows money from its policyholders which it relends to other capital users in the economy; and second, it pools risks that individuals will die during a particular period of time.

Both types of life insurance companies are in business to make a profit for their equity owners in both of their roles, both as a financial intermediary and as a pooler of risks. Although the mutuals and stocks have substantially different forms of legal ownership, they are in direct competition with each other.

The tax system should not be designed to place either segment of the industry at a competitive disadvantage vis-a-vis the other or vis-a-vis other financial intermediaries with whom the life insurance industry competes. Accordingly, in formulating tax rules applicable to the life insurance industry, we believe that the correct focus at the outset should be on economic income.

Clearly, the basic structure of the U.S. tax system contemplates a double tax on stock life insurance companies and on other corporations. That is, once at the company level and again when corporate income is paid to the stockholders.

The role of a double tax for a mutual company because of its form of organization is not clear. But competitive equity in the life insurance industry requires either that all firms be subject to a double tax, or that they all be subject to a single tax.

Although strong arguments can be made against the double tax and are often made against the double tax of our present corporate system, completely relieving the double tax in the insurance industry but not elsewhere would raise competitive problems between the insurance industry and other financial intermediaries.

Consequently, our approach characterizes mutual companies as if their owners are stockholders and subject to double taxation. At the same time, we recognize that application of the full corporate tax rate on accurately measured economic income of either stock or mutual companies could cause the insurance industry to be significantly overtaxed relative to other financial intermediaries. Thus, we realize that if the tax base were to be correctly measured income, a reduced corporate tax rate may be appropriate.

Under traditional corporate tax principles, all life insurance companies would be subject to tax on their profits earned in their capacity as financial intermediaries and on their profits earned as poolers of risk. In addition, their equity owners would be taxed on dividend type returns on equity. Neither stocks nor mutuals are presently taxed in this manner.

Dealing first with the stock companies, there are four significant areas where the computation of stock companies' taxable income deviates from economic income:

First, if a stock company realizes a profit in its capacity as a pooler of risk, that is its underwriting income, only one-half of this income is subject to tax currently.

Second, a portion of the profits earned by a stock company in its capacity as a financial intermediary, that is its investment income, is treated as underwriting income and thus is not subject fully to tax.

Third, stock life insurance companies are allowed certain so-called special deductions that are not based on actual expenses or liabilities.

And fourth, stock life insurance companies, like all life insurance companies, are permitted to deduct estimates of their future liabilities that exceed the present value of those liabilities, thereby deferring taxes that would otherwise be owed.

A mutual life insurance company, like a stock company, operates both as a financial intermediary and as a pooler of risks. The profits from these operations do not accrue to the benefit of a separate class of stockholders, however. Rather, profits are returned to the policyholders, who also own the company.

This dual status is evident when a mutual company distributes a policyholder dividend to its policyholders. Policyholder dividends may be viewed as consisting of three components: first, an equity return paid by the insurance company on the capital provided by the policyholders in their capacity as stockholders of the company; second, a payment of interest to the policyholder on savings; and third, a return of excess premiums.

As in the case of stock life insurance companies, current law applicable to mutual companies deviates from the measure of corporate economic income. There are three principal differences in the case of mutual companies:

First, the policyholder dividends are deductible in full against underwriting income and a portion of investment income of the company. The nondeductible portion bears no necessary relationship to the return to which the policyholders are entitled in their role as stockholders of the company.

Second, the portion of the policyholder dividends that is a dividend type return on equity is not taxed to the policyholders, while stockholders of stock companies are taxed on dividends received;

And third, as is the case with stock companies, mutual life insurance companies may deduct estimates of their future liabilities that exceed the present value of those liabilities.

In our analysis of current law, we find that there are four major and several subsidiary provisions of the existing rules governing the taxation of life insurance companies that we think should be reexamined. The four major areas are: the effective exemption from tax of one-half of a life insurance company's underwriting income; secondly, the deductibility of policyholder dividends; third, the so-called special deductions; and fourth, the complicated subject of the treatment of reserves. Let me mention each of these four areas rather briefly.

The first, the exemption of one-half of underwriting income. It is not only deferred, but effectively exempted. This exemption under current law benefits only the small group of large stock companies that realize underwriting income as computed for tax purposes.

This exemption has created incentives for life insurance companies to attempt to recharacterize their income and expenses so as to maximize their underwriting income and minimize their investment income. It has encouraged life insurance companies to establish multiple subsidiaries to achieve this same goal.

We think tax provisions that cause companies to alter the form in which they do business but not the substance of the business need to be carefully scrutinized. Because of the narrow application of this deferral of one-half of underwriting income and because of its questionable purpose and because of its distorting effect, we seriously question the need for the continued exemption of one-half of a life insurance company's underwriting income.

Turning to the deduction of policyholder dividends, the ability to deduct these dividends is of course a principal concern to the mutual life insurance companies, since policyholders of mutual companies are also their owners. As I pointed out, a portion of the premium paid by the policyholder represents his contribution to the capital of the company, and a portion of the policyholder dividend in turn represents a return on equity similar to that paid to a stockholder.

The 1959 act does a haphazard job of making this distinction at the company level, that is the distinction between the portion of the premium which is contribution to the capital of the company and the portion that is payment for insurance. Under the 1959 act, policyholder dividends are deductible against all underwriting income and against a portion of investment income.

Under current conditions, these rules probably allow an inadequate deduction, since it may not permit full deductions for amounts paid to policyholders as interest on savings. Under different conditions, the deduction could be overly generous.

At the individual level, that is at the policyholder level, no distinction is made among the components of the policyholder dividends, that is, the return on equity, the interest on savings, and the return of excess premiums. All policyholder dividends are excluded from the policyholder's taxable income, apparently on the assumption that they represent solely a return of excess premiums.

We think that a mutual company should be allowed to share investment and mortality gains with its policyholders to the same extent that a stock company could share such gain with its policyholders. However, to the extent that policyholder dividends represent a dividend type return on equity they should not be deductible to the company.

The third item I mentioned is the so-called special deductions, the statutory deferrals for certain nonparticipating contracts, accident and health and group life insurance. Current law contains two special deductions that are designed primarily to permit stock companies nominally to defer and effectively to exempt an additional portion of their income from taxation.

The first of the special deductions allows the company to deduct the greater of 3 percent of its premiums or 10 percent of its increase in reserves for the year attributable to nonparticipating contracts of 5-years or more, and the second allows the company to deduct 2 percent of the premiums for the year attributable to accident and health insurance and to group life contracts.

We are troubled by these special deductions. We question whether the claimed justification for the provisions withstands serious scrutiny. Moreover, insurance companies have entered into noneconomic arrangements primarily to take advantage of these provisions, and we go in in our statement to some of these arrangements at some length, Mr. Chairman. I will not repeat those here.

And finally, the treatment of reserves, which is a quite complicated subject, and I will attempt to summarize some of the considerations that we think need to be reviewed in connection with the entire taxation of life insurance companies, because the treatment of reserves is key. Life insurance companies of course are allowed to set up a reserve to cover future liabilities and to deduct currently additions to the reserve.

These reserve deductions acknowledge the fact that a significant portion of each premium received by the company will be returned with interest to the policyholder or to his beneficiaries. Roughly speaking, the reserve is calculated by first estimating the future death claims the company will be required to pay, reduced by future net premiums, and then by discounting this future estimate by an interest factor which takes into account the time value of money, that is bringing the future net liability back to present value.

While this approach is conceptually sound, the actual system allows insurance companies to accelerate deductions for additions to reserves in three ways: First, current law allows life insurance companies to use very pessimistic mortality assumptions; second, an unrealistically low interest rate is allowed in discounting these future liabilities; third, companies are allowed to use unrealistic assumptions as to the way in which loading charges are allocated among the premiums paid under the contract; and in addition, the tax system now allows an acceleration of deductions by permitting life insurance companies to compute their reserves for tax purposes by using rule of thumb approximations that are inaccurate.

The first two of these deviations from a proper measurement of the present value of the company's future liabilities—both stem from the fact that life insurance companies are allowed to compute their reserves for tax purposes on the same basis as for State regulatory purposes. Since the task of State insurance regulators is to protect the policyholders, the regulators err on the side of establishing excessive reserves.

We suggest that for tax purposes the highly conservative State regulatory assumptions result in an undue acceleration of deductions. Moreover, we question whether life insurance companies should ever be allowed to compute reserves under assumptions more pessimistic than the State regulators require be used.

In computing the deduction for additions to the reserves, future liabilities must first be offset by future premiums, and thus, as I stated earlier, it is proper to take into account the future premiums received. But only the future net premiums should be taken into account, that is, the gross premiums reduced by loading charges.

Even though the net premium received in the first year of a policy may be very small because loading charges are paid primarily out of the first year premium, the companies are permitted a substantial deduction for an addition to reserves during that year. Since the loading charges themselves are currently deductible, this permits a total deduction in excess of the premiums received in the earlier years. We question the policy justification for this treatment.

And finally, let me mention in the area of reserves the preliminary term reserve matters. State insurance regulators generally permit life insurance companies to compute their reserves on one of several preliminary term methods. These methods generally acknowledge that virtually all of the first year premium in a cash value policy is used to pay loading and mortality charges, and thus do not result in any significant addition to reserves in the first year of the policy.

In order to prevent companies using the preliminary term method from being disadvantaged vis-a-vis those companies that use a net level premium method and thus could add to their reserves in the first year, the Code allows these companies to revalue their reserves as if they had been computed using a net level premium method. This revaluation may be done on an exact basis, in which case the company gets the same benefits as if it had been using the net level premium method, or on the basis of two approximation formulas.

We believe that the approximation formulas in the Code, even as modified and as cut back by TEFRA, overstate the adjustment needed to go from the preliminary term reserve to the net level premium reserve, and we think this should be reexamined.

The original rationale for using the approximation formulas was that the smaller life insurance companies did not have the resources to make the calculations necessary to perform the exact revaluations. Given the widespread use of computers today, we think this rationale is no longer persuasive.

In our testimony, Mr. Chairman, we also mention three other issues involved in taxation of life insurance companies. I will not go into those other than to mention the consolidated return issue, which does, by allowing affiliated groups of life insurance companies to take into account the separate taxable income or loss of each member, allow one member of an affiliated group to exclude one-half of its underwriting income from taxation even if the other members of the group incur underwriting losses.

We think this is a real problem since it encourages large insurance companies to divide their life insurance business among separate corporate entities so they will have substantial tax losses even though they have substantial underwriting income.

In summary in the taxation of the company area, let me just very briefly go back through it and point out that we have attempted to set out a conceptual framework for the tax treatment of life insurance companies. The principal features of the framework are:

First, that the tax base would include all economic income with no distinction between investment income or underwriting income;

Second, mutual life insurance companies would be treated as corporations with respect to certain amounts deemed to be corporate profits;

Third, full deduction of amounts credited to policyholders other than in their capacity as stockholders would be allowed;

Fourth, deduction of reserves should more accurately reflect, we think, the present value of future liabilities of the companies;

And finally, adjustment of the effective tax rate of life insurance companies should be made through rate adjustments or comparable across the board or simple adjustments, rather than the very complex system we now have.

We recognize that this glosses over many of the hard problems that the subcommittee is going to have to face. We look forward to working with the subcommittee and with the industry to address these problems.

I appreciate your indulgence, Mr. Chairman. I would be happy to attempt to answer any questions you or the members might have.

[The prepared statement follows:]

Statement of Hon. John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on the taxation of life insurance policyholders and life insurance companies. Life insurance taxation is an important and complicated subject, presenting many interrelated policy issues. While we will discuss in this statement each of the major issues separately to the extent possible, the interrelationships cannot be ignored and we have highlighted them where appropriate.

I. ANALYSIS OF LIFE INSURANCE POLICIES

In determining the proper taxation of life insurance policyholders and companies, it is necessary to understand the economic components of a life insurance policy. Only after separating a policy into its various components is it possible to determine if the tax rules governing them are appropriate. In addition, this analysis is necessary to determine whether the rules governing the tax treatment of life insurance companies are fair in light of the tax treatment of other financial intermediaries, and other businesses generally.

A. Insurance and Investment Components

All life insurance policies can be divided into two components: a pure insurance component and an investment or savings component. The pure insurance component involves a redistribution from the policyholders to the beneficiaries of those policyholders who die. The investment component involves the investment of funds paid by the policyholders between the time that they are received by the insurance company and the time that they are paid out to the beneficiaries of the policies.

There is no simple description of life insurance which adequately describes all of the traditional life insurance products, let alone the multitude of new products which are now sold under the name of life insurance. The products range from term insurance (which may be sold for a period as short as the duration of one airplane flight) for which there is virtually no investment component, to deferred annuities that have little or no insurance element.1/ In between, there is a wide array of products, including traditional whole life policies with level annual premiums and a level death benefit. Less traditional forms of insurance provide extensive variations on these basic themes. Perhaps the only feature common to all life insurance policies is that they involve the payment of one or more premiums by the policyholder to the insurance company in exchange for the obligation of the insurance company to make a payment to beneficiaries named by the policyholder in the event that he or she dies while the policy is in force.

The premium charged for a life insurance policy reflects the amount of both the insurance and investment components. The amount that an insurance company will charge for the insurance component depends on the company's estimate of the probability that the policyholder will die during the period of coverage. This estimate generally will be based on published mortality tables. The result obtained from multiplying the amount of insurance coverage by the estimated probability of death during the particular period is the "mortality charge" for the insurance coverage provided. An insurance company also charges an additional amount, known as a "loading charge," that will cover the company's costs incurred in issuing the policy as well as a portion of its overhead costs and anticipated profit. The mortality and loading charges together may be referred to as the "cost of insurance."

1/ Life insurance companies have long sold annuity contracts that provide for a specified periodic payment for the life annuitants. Again, variations on this basic policy have been marketed in recent years, including single premium deferred annuities and so-called "wraparound" annuities.

The investment component of an insurance policy may or may not be stated explicitly. Cash-value life insurance contracts involve the policyholder paying an additional amount to be held by the company in a fund for his benefit. Interest is paid on the fund at a rate fixed in the policy. Some portion of the fund, together with interest credited thereon, may be used to pay the cost of term insurance in some future period; any balance will be returned to the policyholder (if the policy is surrendered) or to his beneficiaries in the form of death benefits (if the policyholder dies while the policy is in force).

Thus, a policyholder who pays a premium in excess of the cost of insurance for the year in which the premium is paid is, in effect, making a deposit to a savings account. For this reason, the portion of a life insurance premium in excess of the mortality and loading charges for the year in which the premium is paid may be referred to as the "savings deposit." The investment income credited to the policyholder is sometimes called the "inside build-up" under the policy. The total amount of premiums plus investment income held for the benefit of the policyholder at any given time, less the total cost of insurance for all prior periods, is the "cash surrender value" of the policy at that time.2/

B. Current Trends

For several reasons, the investment aspects of a life insurance contract have traditionally been secondary to the insurance component. First, the savings component of a life insurance policy has been linked to, and therefore limited by, the fixed amount of death benefits provided under the policy. Second, the rate of return guaranteed under a life insurance contract was generally lower than prevailing market interest rates. Finally, the cost of the insurance component served as a further disincentive to using life insurance policies primarily as investment vehicles.

In today's financial marketplace, this is no longer the case. All financial intermediaries, including life insurance companies, are in stiff competition for investment dollars. This has led to a proliferation of investment vehicles, many

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2/ In addition, the company may credit additional amounts not guaranteed in the contract in the form of "policyholder dividends" or similar distributions to the policyholder. These amounts, which depend on the company's mortality and investment experience and other factors, may be credited in the form of a premium reduction for the succeeding year, additional paid-up insurance, or an increase in the cash value of the policy. Policyholder dividends are discussed in detail in Part III below.

of which combine features of several more traditional investments. Confronted with this ever-growing range of investment opportunities, investors are becoming increasingly discerning and are moving away from investments which do not pay a competitive after-tax rate of return.

In response to this increased investor sophistication, life insurance companies have been changing their products. Certain companies have designed new life insurance products and reshaped old products (such as the single premium policy) to attract investment dollars even from investors who have little or no interest in insurance protection. These modern insurance policies differ from more traditional insurance in several ways.

First, they pay close to a market rate of return to the policyholder (even though the minimum rate of return guaranteed in the contract is still fixed well below market). Second, in many new policies the traditional link between insurance protection and the savings component of a policy has been broken. In extreme cases, the investment component of the so-called life insurance contract is so large and the insurance component is so small that the policy differs little from an investment account in the name of the policyholder with the insurance company. Third, a type of insurance now available, known popularly as universal life insurance, allows the policyholder discretion as to the timing and amount of premium payments. Finally, certain modern life insurance contracts allow the policyholder to choose the actual investment use to which his money is put (*e.g.*, a mutual fund).

C. Examples of Cash-Value Insurance Policies

The relationship between the investment and insurance components of a cash-value life insurance policy may be illustrated by the following examples. All of the examples involve a policy purchased by an individual who is 35 years old. In each case, the rate of return on amounts held for the benefit of the policyholder is 4 percent and the mortality rates used are those found in the 1958 Commissioners' Standard Ordinary (CSO) Mortality Table. Finally, loading charges are assumed to be zero. These assumptions simplify the analysis somewhat and do not significantly alter the economic relationships from that which one would find in policies with loading charges, variable investment return, and variable mortality charges.

Example 1 -- A Level Premium Whole Life Policy

The first example involves a policy that calls for the annual payment of a level premium until the death of the insured in exchange for a level death benefit of $100,000. The policy endows at age 99. (A policy is said to endow when the cash surrender value of the policy is equal to the death benefit.) A policy which endows at age 95 or later is called a "whole life" policy.

Based on the assumptions set forth above, the level premium for this policy is $1,445. The allocation of premiums between mortality charges and the savings deposit, and the investment income under this policy are set forth in Table 1 and Chart 1, which are attached to this testimony.

A few general observations may be made. First, while the death benefit provided under the policy remains level at $100,000, the amount of insurance protection that the company must provide at any given time is equal to only the excess of $100,000 over the balance in the policyholder's savings account at the beginning of the year. For example, since the policyholder's savings account at age 56 is $33,560, the amount of insurance protection during that year is equal to $66,440 (see column 4).3/ Another way of stating this is that a whole life policy of this type is, in substance, a contract that calls for an increasing savings account and a correspondingly decreasing amount of renewable term insurance.

Even though the mortality charge for a fixed amount of insurance increases steeply as the policyholder grows older, the fact that the amount of insurance protection declines steadily over the life of the policy means that the actual mortality charges under the policy increase much more slowly.

3/ The balance in the savings account includes the cash surrender value of $33,059 (see column 7) plus the savings deposit portion of the current premium of $501 (gross premium of $1,445, column 2, minus mortality charge of $904, column 5).

This allows the investment income credited to the policyholder to grow constantly, even where the cash value earns interest at the modest rate of return of only 4 percent. In fact, until the policyholder reaches the age of 63, the entire mortality charge for the year may be paid out of the current year's premium; the entire investment income and the excess premium for those years are credited to savings and simply increase the cash surrender value of the policy. Furthermore, in no year of the policy does the mortality charge exceed the sum of the annual premium and the investment income for that year (*i.e.*, the cash surrender value never decreases).

Finally, it may be observed from Chart 1 that, at all times during the life of the policy, the cumulative interest earnings are roughly equivalent to the cumulative mortality charges. The same would be true of a policy with loading charges included.

Example 2 -- A Single Premium Whole Life Policy

The second example illustrates a policy that calls for a single premium to be paid at the beginning of the policy term. Based on the assumptions described above, the single premium necessary to purchase a policy providing a $100,000 level death benefit, with endowment at age 99, is $27,600. Chart 2 and Table 2, attached, show the various components of this policy.

Because of the large initial deposit, the amount of pure insurance protection which must be provided is significantly less than under a level premium policy. This results in lower mortality charges and a much quicker accumulation of investment income. The cumulative investment income is more than double the amount of the cumulative mortality charge until the last few years of the policy. Hence, Examples 1 and 2 illustrate that a single premium policy has a significantly higher investment component and a smaller insurance component than a level premium policy providing the same death benefit.

Example 3 -- A Single Premium Policy, Endowing at Age 65

As has already been seen, a single premium policy involves a significantly higher investment component than a comparable level premium policy. Moreover, in both kinds of policies, the earlier the age at which the policy endows, the greater the investment orientation. Consider, for example, a $100,000 single premium policy for a 35-year-old man which endows at age 65. Under the same assumptions as above, the single premium for a policy of this type is $34,800. This amount grows to $100,000 in 30 years, even with the modest assumed interest rate of 4 percent. Chart 3 and Table 3, attached, describe this policy more fully and allow for easy comparison with the first two examples.

The total mortality charges under this policy are only $9,400. Hence, virtually all of the cumulative interest earnings of $74,600 are used to increase the cash surrender value of the policy. Of course, if a higher interest rate were credited to the policyholder, the investment orientation of this policy would be even more pronounced.

Example 4 -- An Increasing Death Benefit Policy

A policy that calls for an increasing death benefit will require higher premiums than one which does not. This means the policy will have generally higher levels of cash value and hence a lower level of insurance protection required. This in turn reduces mortality charges and allows for a faster inside build-up. Thus, paradoxically, a policy that calls for an increasing death benefit is much more highly investment oriented than one which does not.

Consider, for example, a single premium policy for a 35-year-old man with an initial death benefit of $100,000 which automatically increases by 3.5 percent annually, compounded. The annual interest rate credited under the policy is 4 percent. The policy endows at age 99.

The single premium for this policy is $84,200.4/ Since the return credited is higher than the rate of increase of the death benefit, and since the mortality charges are so low, the amount of insurance protection never exceeds $21,000. By the time the policyholder reaches the age of 65, investment income of $196,500 will have been credited, while the total cost of the insurance coverage is slightly greater than $6,000. Chart 4 and Table 4 graphically illustrate the investment orientation of this policy.

4/ If the death benefit grew at the same 4 percent rate as the return credited to the policyholder, the premium would be $100,000 and the policy would have no insurance element whatsoever.

II. TAXATION OF LIFE INSURANCE POLICYHOLDERS

A. Description of Current Law

1. Deferral of Tax on Investment Income

Perhaps the most significant tax benefit afforded cash-value life insurance is that the investment income earned on the policyholder's savings account is not subject to current income taxation. The policyholder is not treated as having constructively received income by virtue of the increase in the cash surrender value of his policy, even though interest income on other savings accounts is generally subject to tax.

2. Exclusion of Proceeds Paid at Death

Under section 101(a) of the Internal Revenue Code, any amount paid under a life insurance contract by reason of the death of the insured is excluded from the gross income of the beneficiary.5/ This exclusion applies to the entire amount of death proceeds, part of which is insurance protection, part of which is a return of the policyholder's "savings deposit," and the balance of which is a distribution of investment income earned.

Thus, in Example 1, if the insured died at age 65, the death proceeds of $100,000 would have an insurance component of $50,361 (the excess of $100,000 over the balance of the savings account value of $49,639). The return of the savings deposit part of premiums would be $21,871 (total premiums paid of $44,813 less insurance costs of $22,942). The balance of $27,768 would be the distribution of investment income.

5/ Also, with proper planning, the death proceeds may be excluded for estate tax purposes from the gross estate of the insured by making the proceeds payable to a beneficiary other than the estate and by having the insured transfer prior to his death all of the "incidents of ownership" of the policy.

Section 101 converts the deferral of tax on the investment income into a permanent exclusion. The greater the investment orientation of the policy, the greater the benefit of this exclusion. For instance, in Example 2, the amount of investment income which permanently escapes tax if the insured dies at the age of 65 would be $52,300. In Example 3, the amount would be $70,700. In Example 4, the amount excluded would be $185,900.

3. Mismeasurement of Policyholder Investment

The section 101(a) exclusion from gross income applies only to amounts paid by reason of the death of the insured. If a policyholder surrenders his life insurance policy before death in exchange for the cash surrender value, he must recognize ordinary income equal to the excess of the cash received over his investment in the policy.

The Code treats the policyholder's investment in the policy as the aggregate of his gross premiums. No reduction is made for the portion of the premiums which has been used to pay mortality charges, even though these are personal expenses of the policyholder and would not be deductible if paid directly. For example, in the level premium whole life insurance policy presented above, if the policyholder surrendered the policy at age 65 for its cash value of $51,625, he would be taxed on income of only $6,812 (*i.e.*, the excess of the cash received over the aggregate premiums of $44,813). This compares to the actual amount of investment income distributed of $29,754.

4. Ordering Rules on Withdrawals

The rule described in the preceding paragraph applies to cash withdrawals from a life insurance contract as well as to complete surrenders. In calculating the amount to be included in the policyholder's taxable income, withdrawals are treated as being made first out of the policyholder's investment in the policy. Only after the entire investment has been withdrawn is any amount included in taxable income. Thus, in Example 1, a withdrawal of up to $44,813 would be completely free from tax.

5. Treatment of Policyholder Loans

Policyholder loans are respected as loans and are not treated as withdrawals, even if they are not repaid prior to the death of the insured. Moreover, interest paid on policyholder loans is generally deductible even though the income earned on the policy, which accrues for the benefit of the policyholder, is not subject to current tax.

Section 264 of the Code places some restrictions on the deductibility of interest on policy loans. Section 264(a)(2) provides that no deduction is allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Section 264(a)(3) denies the deduction for interest paid on loans on contracts other than single premium contracts if there is "a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract . . .." However, this paragraph does not apply if any one of the four "safe harbor" conditions set forth in Code section 264(c) are satisfied.

The first of these safe harbors has been used by life insurance companies to market policies with a fixed schedule of borrowing that provide substantial tax advantages to the policyholder. Under some of these plans, the tax advantages are so large that they have been marketed primarily as tax shelters and only incidentally as life insurance.

6. Group-Term Life Insurance

Section 79 of the Code deals with group-term life insurance. In general, this provision encourages employers to purchase a plan of group-term life insurance for their employees by providing that no amount is included in the employee's gross income for the cost of up to $50,000 of insurance. The cost of coverage provided in excess of $50,000 is determined on the basis of a uniform premium table. An unlimited exclusion, however, is provided to retired and disabled employees.

In TEFRA, Congress added a new section 79(d) to the Code which provides that the $50,000 exclusion is denied to any "key employee" under a "discriminatory group-term life insurance plan." Section 79(d) does not, however, deny the benefits of the use of the uniform premium table, nor the unlimited exclusion for retired employees, to a group-term life insurance plan which is found to be discriminatory.

B. Policy Considerations for Current Tax Treatment

Proponents of the favorable tax treatment of cash value life insurance have asserted that it serves three significant policy goals. First, the tax treatment encourages people to purchase life insurance protection for their families. In the event of the death of a working spouse, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving government of an obligation it otherwise would have to assume.

The second policy consideration that has been advanced for exempting the income earned on investments in cash-value life insurance policies is that it encourages people to save on a fixed schedule through life insurance. This savings program effectively reduces the need for pure insurance protection since the total amount needed to provide a fund sufficient to protect the insured's beneficiaries is provided in part by the amount saved. Exempting the income from tax also allows the insurance company to offer a package of investment and insurance with a higher after-tax rate of return, lower premiums, or a combination thereof. This results in the purchase of a greater amount of cash-value insurance. Moreover, the liberal rules on surrenders and loans permit taxpayers to use the cash surrender value of life insurance either as a retirement fund or as a vehicle to fund major financial obligations without paying tax on the accumulated investment income.

The third policy consideration is that savings through life insurance companies has fostered long-term investment. While cash-value policies are in force, the amounts saved by the policyholders are combined to form a large block of capital which the insurance company may invest on a long-term basis. This concentration of investment capital historically has allowed life insurance companies to play a significant role in capital formation in this country.

The fact that the tax benefits afforded cash-value life insurance are greatest when the investment aspects are highest shows that the policy reasons underlying the current tax system include the encouragement of savings through life insurance policies. This leads one to question why the same kinds of incentives are not provided to other financial investments. Other tax-preferred investments, such as qualified pension plans and individual retirement accounts, have significant limitations on the timing and amount of contributions, withdrawals, loans, etc. Comparable financial investment vehicles without these limitations generally do not receive the tax-free (or at least tax-deferred) status which is afforded to savings through life insurance.

One might also question why the tax incentives for life insurance are granted in their present form. The benefits are greatest when the investment orientation is the highest and the least when the insurance component is paramount. Purchasers of term insurance receive virtually no benefit from the failure to tax investment income currently. Furthermore, the tax benefits are smallest to policyholders in the lowest tax brackets. These are arguably the people who most need encouragement to purchase life insurance protection.

Finally, it should be noted that the development of policies which allow policyholders to retain investment control over the cash value may be inconsistent with the policy justification that concentration of policyholder funds in the hands of a life insurance company for reinvestment fosters long-term capital formation. The amounts held in such policies are not available to the life insurance company for long-term reinvestment. Moreover, it is unclear why an investment controlled by the owner should become tax-exempt (or at least tax-deferred) simply because it is held through a life insurance company and some of the proceeds are used to purchase term insurance protection.

C. Areas of Legislative Concern

Treasury believes that four aspects of the taxation of life insurance policyholders merit careful reconsideration at this time. First, a definition of "life insurance" should be added to the Code to prevent policies which are overly investment-oriented from obtaining the favorable tax benefits that are given to life insurance. Second, the tax benefits made available to those policies which do qualify as life insurance should be consistent with sound policy objectives. Third, serious thought should be given to tightening the tax rules relating to surrenders, withdrawals, and policy loans so that the favorable tax benefits given to life insurance are not available where the underlying policy objectives of these tax benefits are defeated. Finally, certain aspects of the tax treatment of group-term life insurance should be reassessed.

1. Definition of Life Insurance

The Internal Revenue Code contains no comprehensive definition of life insurance designed to deny the tax benefits of life insurance to policies with an excessive investment orientation.[6] In light of recent changes in the life insurance industry, such a definition is now a necessity. In formulating this definition, a traditional level premium, level death benefit whole life policy could be used as a clear example of a policy which is not overly investment oriented. From this starting point, it is useful to bear in mind how certain features of a life insurance policy affect its investment orientation. In particular:

- A single premium policy is considerably more investment-oriented than a level premium policy providing the same death benefit. More generally, the shorter the period over which premiums are required to be paid, the greater the investment orientation.
- The earlier a policy endows, the greater is its investment orientation.
- A policy which calls for increasing death benefits is more highly investment-oriented than one which calls for a level death benefit.

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[6] The only definition of life insurance currently found in the Code is in section 1035 (relating to certain exchanges of insurance policies). The Code first defines a contract of "endowment insurance" as a contract with a life insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life. A contract of "life insurance" is then defined as an endowment contract which is not ordinarily payable in full during the life of the insured.

The first attempt to limit the investment orientation of a life insurance contract was made in section 101(f), added by TEFRA, which deals only with "flexible premium life insurance contracts" such as universal life insurance. Section 101(f) is a temporary measure, designed to allow sellers of universal life insurance to compete on a equal basis with sellers of more traditional policies while providing some limits on the extent to which universal life could be used as an investment vehicle. Hence, the precise combination of limitations contained in this statute may not be appropriate for a permanent general definition of life insurance. For example, we believe that it is appropriate to examine whether single premium policies and policies which endow at an early age should be treated as life insurance for tax purposes. Nevertheless, the requirements contained in section 101(f) give some indication of the kinds of tests which might be incorporated into such a definition.

2. Tax Treatment of Life Insurance

The Treasury Department supports the continuation of properly structured tax incentives to encourage the purchase of life insurance. Specifically, we support the continued exclusion from gross income of all amounts payable by reason of the death of the insured. The insurance component of the proceeds is simply a redistribution of premiums which are generally paid out of after-tax dollars and is properly exempt from tax under general tax principles. The portion which represents a return of premiums also is properly exempt from tax to the extent the premiums were paid out of after-tax dollars.7/ As to the exemption for the portion of death proceeds which is attributable to investment income, we believe that it is inappropriate to reconsider this long-standing feature of the tax law at the present time.

7/ Premiums are not invariably paid out of after-tax income. For example, premiums on employer-provided group-term life insurance policies are paid out of income which is deductible by the employer and excluded from the employee's gross income.

It may be appropriate, however, to consider whether all investment income under a life insurance policy should continue to be exempt from current tax. This exemption applies to amounts which will eventually be used to pay future mortality costs as well as amounts which simply increase the policyholder's savings account. While the Treasury believes long-term savings should be encouraged, we question why all savings through a life insurance policy should receive more favorable treatment than savings through other financial intermediaries.

The treatment of investment income bears an important relationship to the definition of life insurance. To the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the investment income under policies that fall within the definition. Conversely, if a looser definition is adopted, it seems appropriate to place some limits on the tax-free accrual of investment income in order to prevent savings through life insurance from obtaining an unfair advantage over other forms of savings.

If some tax were to be imposed on investment income earned under a cash-value life insurance policy, a tax at the corporate level might be easier to administer than a tax at the individual level with an accompanying withholding system. Because of the difficulty of attributing investment income to specific policyholders, some care would have to be given to establishing the appropriate base and rate of such a tax. In addition, some means would have to be found to prevent mutual insurance companies from avoiding the tax in large part through the payment of policyholder dividends.

3. Rules Regarding Surrenders, Withdrawals, and Policy Loans

Using a life insurance policy contract primarily as an investment vehicle is greatly facilitated by the tax rules regarding policyholder withdrawals, surrenders, and loans. Because of the way in which policyholder investment is computed and the ordering rule regarding withdrawals, a policyholder may withdraw up to his cumulative premium payments free from tax. Moreover, even if the entire policy is surrendered, the failure to subtract the cost of insurance from the policyholder's investment in the policy gives a significant permanent tax benefit.

Alternatively, a policyholder who wishes to cash in his investment may simply borrow the entire cash surrender value of the policy. Since the loan is generally treated as such even if the policyholder has no intention or obligation to repay the amount borrowed prior to his death, nothing is included in the policyholder's income at the time of the loan. When the policyholder dies, the loan proceeds are simply subtracted from the death benefit payable to the beneficiaries. Furthermore, since interest paid by the policyholder to the company on the loan is deductible, a policyholder frequently will find it advantageous to borrow against his policy simply to invest the proceeds elsewhere.

Treasury suggests that consideration be given to making three changes in the present system. First, in calculating a policyholder's "investment" in a life insurance policy for purposes of determining gain when the policy is surrendered prior to death, the portion of the aggregate premiums which have been used to pay the cost of insurance should be subtracted. In failing to do this, the existing system effectively allows the cost of insurance to be paid out of pre-tax dollars with no recapture tax if the policy is surrendered prior to death.

Second, the ordering rules regarding the treatment of withdrawals should be reversed. Any withdrawal of cash from an insurance policy should be treated first as taxable income to the extent cash surrender value of the policy exceeds the policyholder's investment in the policy. Only after this excess has been paid out in full should additional amounts be treated as non-taxable return of premiums. This new ordering rule was instituted in TEFRA for annuity contracts with Treasury's support. Treasury would also support the corresponding change for life insurance and endowment contracts.

Finally, Treasury believes that some limitations should be placed on policyholder loans. Such limitations are necessary to prevent wholesale avoidance of the tax rules regarding surrenders and withdrawals, even under present law, and are even more essential if the changes described above are made. The rules regarding loans from qualified employer plans, contained in section 72(p) (added by TEFRA), might serve as a guideline for such rules. We see no reason why loans from life insurance policies should receive more favorable treatment than loans from qualified employer plans.

As an alternative to the above, the limitations on the deductibility of interest under policyholder loans contained in section 264 could be tightened. However, as the present experience has shown, a rigid set of rules in this case can serve as a blueprint for tax avoidance. Hence, we would favor the approach described above over an extension of section 264.

4. Group-Term Insurance

Certain problems have arisen under section 79 that should be addressed. First, use of a uniform premium table should be reconsidered. In 1964, when section 79 was enacted, the provision was perhaps justified as a rule of administrative convenience. However, a uniform table unfairly penalizes some employees and gives others an unwarranted windfall. Also, the use of the uniform table is susceptible to abuse. Second, consideration should be given to eliminating the unlimited exclusion for coverage provided to retired employees. The need for insurance protection once a person has retired is relatively small. Moreover, the exclusion for group-term life insurance for retired employees allows, in many situations, a key employee to avoid the anti-discrimination provisions of the pension tax laws. Finally, the anti-discrimination rules of section 79(d) should be extended to all benefits provided by section 79, not simply the $50,000 exclusion.

III. TAXATION OF LIFE INSURANCE COMPANIES

The Internal Revenue Code provisions that govern the tax treatment of life insurance companies are some of the most complex and least logical provisions in the tax law today. The complexity of the statute, which was enacted in substantially its present form in 1959, was summarized aptly by Judge Fletcher of the former U.S. Court of Claims: "These complex and obscure provisions bear all the earmarks of a conspiracy in restraint of understanding."[8]

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[8] Lincoln Nat. Life Ins. Co. v. United States, 582 F. 2d 579, 583 at n.1 (Ct. Cl., 1978).

In large part, the complexity results from the enactment of a statutory scheme that was based primarily on two factors: the level of revenue sought from the industry; and the "requirement" that the revenue be raised from the different segments of the industry (i.e., the stock and the mutual life insurance companies) in proportions that the segments agreed fairly allocated the industry's tax burden. The tax provisions were crafted to meet these artificial revenue constraints.

The existing system of taxing life insurance companies is seriously flawed, and is in need of a major overhaul. Since 1959, changes in economic conditions have led to changes in the way insurance companies operate and in the type of policies they provide. In addition, life insurance companies compete with other financial intermediaries to an increasing extent. The application of the existing tax rules to these changed economic conditions is no longer satisfactory.

I would like to emphasize at the outset that the Treasury Department is not here today to suggest the appropriate aggregate tax burden of the life insurance industry. Rather, our goal is to work toward replacing the cumbersome and outdated existing system with a statute which is simpler, fairer, and more rational.

A. General Observations

A unique aspect of the life insurance industry is that its business is conducted in roughly equal portions by stock and mutual companies. The stock life insurance companies are ordinary corporations that operate in the insurance business. They are owned by their stockholders, and their policyholders are their customers. A mutual life insurance company is basically similar to a stock life insurance company. The legal organization of a mutual insurance company is different in that it does not have a separate class of stockholders. The owners of a mutual company are its customers: a person who buys a participating life insurance policy from a mutual company acquires a life insurance policy and a right to share in the "surplus", or profits, of the company.

Both types of companies sell a large volume of cash-value life insurance policies. As discussed earlier, this type of insurance includes two components: a savings fund and pure insurance protection. Hence, in issuing life insurance policies, a life insurance company serves two roles. First, it operates as a financial intermediary in that it borrows money from its policyholders which it relends to other capital users in the economy. Second, it pools the risks that individual policyholders will die during a particular period of time.

Both types of life insurance companies are in business to make a profit for their "equity owners." In particular, they seek to make a profit in their capacity as financial intermediaries by lending their policyholders' savings at the highest possible rate of return. They also seek to make a profit in their capacity as poolers of risks by charging their policyholders a higher premium for assuming the risks than they expect to pay to the beneficiaries of their policyholders.

Although the mutual and stock life insurance companies have substantially different forms of legal ownership, they are in direct competition with each other. The tax system should not be designed to place either segment of this industry at a competitive disadvantage vis-a-vis the other. Moreover, since life insurance companies increasingly operate in competition with other financial intermediaries, the extent to which the tax system maintains distinctions among these competing entities must be scrutinized carefully. Accordingly, in formulating tax rules applicable to the life insurance industry, we believe that the correct focus at the outset should be on economic income.

The existence in the insurance industry of many firms that are not incorporated, but are in competition with corporations, highlights the competitive importance of the corporation income tax. Clearly the basic structure of the U.S. tax system contemplates a double tax on stock life insurance companies as on other corporations. That is, the profits of the company would be taxed once at the company level and again when paid to stockholders or realized through sales of appreciated stock.

Competitive considerations aside, the role of a double tax for a mutual company is much less clear. A mutual company has owners and it seeks to maximize the profits of those owners. But it is possible to characterize the mutual company as being similar to a large cooperative and, thus, not subject to a double tax on the profits of the owners.

Competitive equity in the life insurance industry requires either that all firms be subject to a double tax or that all be subject to only a single tax. The need for competitive equity within the life insurance industry, however, does not indicate which alternative is appropriate. Strong arguments against the double tax can be and are made.

However, since the general structure of our tax law imposes a double tax on corporations, completely relieving that double tax in the insurance industry, but not elsewhere, would raise competitive problems between the insurance industry and other financial intermediaries. Consequently, our approach characterizes mutual companies as if their owners are stockholders subject to double taxation.

At the same time, we recognize that application of the full corporate tax rate on accurately measured economic income of either stock or mutual companies could, cause the insurance industry to be significantly overtaxed relative to other financial intermediaries. As a result, we realize that, if the tax base were to be correctly measured income, then a reduced corporate tax rate or a simple deduction applicable to all life insurance companies may be appropriate. Such an adjustment would be preferable to a series of complex statutory provisions that are virtually incomprehensible, and that produce unintended tax consequences as economic conditions change.

Under traditional corporate tax principles, all life insurance companies would be subject to tax on their profits earned in their capacity as financial intermediaries and on their profits earned in their capacity as poolers of risks. In addition, their equity owners would be taxed on dividend-type returns on equity. Neither stock nor mutual life insurance companies presently are taxed in this manner.

The most significant areas where the tax rules applicable to stock life insurance companies deviate from measuring economic income may be summarized as follows:

- if a stock company realizes a profit in its capacity as a pooler of risks (its "underwriting income"), only one-half of this income is subject to tax currently;

- a portion of the profits earned by a stock life insurance company in its capacity as a financial intermediary (its "investment income") is treated as underwriting income, and thus is not fully subject to tax;

- stock life insurance companies are allowed certain "special deductions" that are not based on actual expenses or liabilities; and

- stock life insurance companies, like all insurance companies, are permitted to deduct estimates of their future liabilities that exceed the present value of those liabilities, thereby deferring taxes that otherwise would be owed.

A mutual life insurance company, like a stock company, operates both as a financial intermediary and as a pooler of risks. The profits from these operations do not accrue to the benefit of a separate class of stockholders. Rather, profits are returned to the policyholders, who also own the company. This dual status is most evident when a mutual company distributes dividends to its policyholders.

Policyholder dividends may be viewed as consisting of three components: an equity return paid by the insurance company on the capital provided by the policyholders in their capacity as stockholders; a payment of interest to the policyholder on savings; and a return of excess premiums. Under the current corporate tax system, the equity return would not be deductible by the company and would be taxable as a dividend to the policyholder; the interest component would be deductible by the company and taxable to the policyholder; and the refund of excess premiums would be treated as an adjustment to the purchase price of the insurance policy, and thus, deductible by the company (since it was included in gross income when received) and nontaxable to the policyholder (assuming that no deduction was taken by the policyholder when it was paid).

As in the case of stock life insurance companies, current law applicable to mutual life insurance companies deviates from a measure of corporate economic income. The principal differences are as follows:

- policyholder dividends are deductible in full against underwriting income and a portion of the investment income realized by the company. The nondeductible portion bears no necessary relationship to the return to which the policyholders are entitled in their role as "stockholders";

- the portion of the policyholder dividends that is a dividend-type return on equity is not taxed to policyholders (while stockholders of stock companies are taxed on dividends received); and

- as with stock companies, mutual life insurance companies may deduct estimates of their future liabilities that exceed the present value of those liabilities.

B. Analysis of Current Law

There are four major and several subsidiary provisions of the existing rules governing the taxation of life insurance companies that should be examined closely. The four major provisions are:

- the effective exemption from tax of one-half of a life insurance company's underwriting income;
- the deductibility of policyholder dividends;
- the special statutory deductions; and
- the treatment of reserves.

These matters are discussed in detail in the material which follows.

1. Effective Exemption of One-Half of Underwriting Income.

Under the 1959 Act, a life insurance company is taxed on its total income if it realizes an underwriting loss. However, if it earns underwriting income, only one-half of that income is subject to tax.

The effective exemption from tax of one-half of a life insurance company's underwriting income under current law benefits only the small group of large stock companies that realize underwriting income as computed for tax purposes.[9] In addition, this exemption has created incentives for life insurance companies to attempt to recharacterize their income and expenses so as to maximize their underwriting income and to minimize their investment income. It also has encouraged life insurance companies to establish multiple subsidiaries to achieve this same goal. Tax provisions that cause companies to alter the form in which they do business, but not the substance of that business, should be carefully scrutinized to make sure that the reasons for their existence are viable. The incentives created under the 1959 Act are illustrated in an example, below, that discusses the application of consolidated return rules to life insurance companies.

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[9] The Code is nominally drafted in terms of a deferral of tax on one-half of underwriting income. However, deferred income of life insurance companies has rarely been restored to taxation and the practical effect of the deferral to date has been exemption from taxation. If the tax treatment of life insurance companies is significantly revised, the future treatment of the accumulated deferred income would have to be considered.

Prior to the 1959 Act, underwriting income was completely exempt from Federal income tax. The legislative history of the 1959 Act indicates that the exemption of one-half of a life insurance company's underwriting income was enacted as a precaution when Congress first made underwriting income subject to tax. Congress wanted to insure that the new rules would not result in overtaxation of income reported on an annual basis from long-term life insurance contracts.

The fears of Congress do not appear to have been warranted. We are not familiar with any evidence that indicates that the annual measure of income generally will not measure fairly the profit properly allocable to that year as a result of the presence of long-term contracts. The level of risk assumed by most life insurance companies in issuing such long-term contracts has not been shown to be significantly higher than that inherent in a broad range of economic activities.10/ Indeed, a substantial portion of the life insurance company's business consists of term life insurance and pension asset management. These lines of business are subject to relatively little long-term risk.

Activities involving risks comparable to those assumed by life insurance companies are undertaken by many other businesses, all of which are taxed on an annual basis. If unanticipated losses occur, provision is made in the law, for life insurance companies as well as for other types of businesses, to apply these losses in certain prior and subsequent years. Unless these general carryback and

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10/ While life insurance companies provide coverage that guarantees that the company will insure risks in subsequent years (for example, in a guaranteed renewable term insurance policy the company obligates itself to provide term insurance protection in subsequent years). These policies generally are priced in a manner that compensates the company for the exposure to the future risks.

carryover provisions are inadequate, no special provision is necessary to mitigate any adverse consequences of taxing life insurance companies on the basis of an annual accounting period.

Because of its narrow application, its questionable purpose and its distorting effects, we seriously question the need for the continued exemption of one-half of a life insurance company's underwriting income.

2. Deduction of Policyholder Dividends

The ability to deduct policyholder dividends is of principal concern to mutual life insurance companies. As noted earlier, policyholders of mutuals are also their owners; a portion of their premium payments represents their contribution to the capital of the company, and a portion of the policyholder dividends represents a return on equity similar to that paid to a stockholder.

The 1959 Act does a haphazard job of making this distinction at the company level. Under the 1959 Act, policyholder dividends are deductible against all underwriting income and against a portion of investment income. Under current conditions, these rules probably allow an inadequate deduction since it may not permit full deductions for amounts paid to policyholders as interest on savings; under different conditions, the deduction could be overly generous. At the individual level, no distinction is made among the components of policyholders dividends (*i.e.*, the return on equity, interest on savings and return of excess premiums). All policyholder dividends are excluded from the policyholder's taxable income on the apparent assumption that they represent solely a refund of excess premiums.

The task of isolating the portion of the policyholder dividend that is a return on equity has become more difficult since 1959 due to the breakdown of the traditional allocation of gains realized on cash value life insurance between the company and the policyholder. Historically, all investment and underwriting gain realized by a stock life insurance company on nonparticipating policies belonged to the owners of the company. In light of less stable interest rates and continuing improvements in mortality, stock companies have begun selling policies which are nominally nonparticipating but which allow the policyholder to share the investment and mortality gains. Stock life insurance companies claim that all investment and mortality gains shared with their policyholders should be deductible by the companies notwithstanding the fact that these amounts are economically indistinguishable from the classic form of policyholder dividends. In the context of a comprehensive revision to the system of taxing life insurance companies, such deductions would be appropriate. However, if the mutual companies cannot deduct comparable amounts, they are likely to be placed at a serious competitive disadvantage.

We believe that a mutual company should be allowed to share investment and mortality gains with its policyholders to the extent that a stock company could share such gains with its policyholders. However, to the extent that policyholder dividends represent a dividend-type return on equity, they should not be deductible.

Accordingly, we believe that the 1959 Act's limitation on the deduction of policyholder dividends should be reconsidered. Rather than limiting the deduction to underwriting income and an arbitrary portion of investment income, as present law provides, it would seem appropriate to use the "corporate profit" of a mutual life insurance company as the measure of the nondeductible portion of policyholder dividends.11/ This profit cannot be measured directly. One possible method of approximating this profit would be to compute the capital of the mutual company that is supplied by its policyholders, and to impute a return on this capital. Such a limitation on the deductibility of policyholder dividends would be more closely tied to the rationale for limiting the deductibility of policyholder dividends than the current rule.

3. Other Explicit Statutory "Deferrals": Special Deductions For Certain Nonparticipating Contracts, Accident and Health and Group Life Insurance

Current law contains two "special" deductions that are designed to permit stock life insurance companies nominally to defer (and effectively to exempt) an additional portion of their income from taxation. Prior to TEFRA, a company could deduct these amounts only to the extent of its underwriting income plus $250,000. One of the temporary provisions of TEFRA permits stock life insurance companies to deduct at least 85 percent of the special deduction for nonparticipating contracts even if it had underwriting losses.

11/ Policyholders generally are not taxed at the individual level on the portion of policyholder dividends that represent a dividend-type return on equity. Full parity between stock and mutual life insurance companies would require that this issue be addressed.

The first of the special deductions allows a company to deduct the greater of 3 percent of its premiums or 10 percent of its increase in reserves for the taxable year attributable to nonparticipating contracts issued or renewed for periods of five years or more. The second allows a company to deduct 2 percent of the premiums for the taxable year attributable to accident and health insurance contracts and group life contracts.

Treasury is troubled by these special deductions. We question whether the claimed justification for these provisions withstands serious scrutiny. Moreover, insurance companies have entered into non-economic arrangements primarily to take advantage of these provisions.

The legislative history of the 1959 Act indicates that the deduction for nonparticipating policies was intended to provide assistance to stock life insurance companies in competing in the capital markets. These companies must maintain surplus to meet unexpected risks, and the companies must pay a fair return on this surplus to their stockholders.

Prior to the enactment of TEFRA, this deduction was allowed only if a life insurance company had underwriting income. Only a relative handful of companies were in this position. Most of the stock life insurance companies, including the vast majority of the smaller companies who presumably would have the greatest difficulty gaining access to the capital markets, received no benefit. This indicates that this provision was not needed to enable all of the stock companies to compete in the capital markets; it simply provided a windfall to a handful of companies.

The deduction for nonparticipating contracts has been used to obtain tax benefits that appear to be unintended. Life insurance companies claim that reinsurance contracts that are nominally nonparticipating, although economically indistinguishable from participating policies, are eligible for this deduction. In addition, taxpayers claimed that reinsurance of participating life insurance policies was eligible for the benefits of this provision. If sustained this aggressive position could effectively expand the deduction for nonparticipating policies to all participating policies.

Similarly, the special deduction for accident and health and group life insurance policies is difficult to justify. The purpose stated for this provision in the legislative history was that a special deduction was needed to compensate insurers for issuing certain group policies with respect to which the company had less diversification of risk than it has in connection with its individual life insurance business. As noted earlier, if a company incurs losses, the

Code permits the company to apply these losses against income earned in certain prior and subsequent taxable years. These provisions insure that a life insurance company will not be overtaxed on the income earned from their group and accident and health business.

In addition, the tax law already treats these forms of insurance in a favorable manner. Employers may deduct the costs of providing these types of insurance while all or a portion of the value of the insurance protection is not taxed to employees.

Finally, the benefit of this provision is restricted to the handful of the largest stock life insurance companies with underwriting income. These companies generally are large enough to diversify the risks on these types of insurance. We seriously question whether there is any justification for this selective tax benefit for this group of taxpayers.

4. Treatment of Reserves

Life insurance companies are allowed to set up a "reserve" to cover net future liabilities and to deduct currently additions to this reserve. These reserve deductions reflect the fact that a significant portion of each premium received by the company will be returned, with interest, to the policyholder or his beneficiaries. Roughly speaking, the reserve is calculated by first estimating the timing and amount of future death claims the company will be required to pay, reduced by net future premiums, and then by "discounting" this future estimate by an interest factor which takes into account the time value of money.[12]

While this approach is conceptually sound, the actual system allows life insurance companies to accelerate deductions for additions to reserves in three ways. First, current law allows life insurance companies to use very pessimistic mortality assumptions to estimate their future death claims. Second, an unrealistically low interest rate is allowed in discounting these future liabilities. Third, companies are allowed to use unrealistic assumptions as to the way in which loading charges are allocated among premiums paid under the contract. In addition, the tax system allows an additional acceleration of deductions by permitting life insurance companies to compute their reserves for tax purposes by use of rule-of-thumb approximations that are inaccurate.

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[12] The net premium is equal to the gross premium reduced by loading charges. Loading charges are used primarily to offset the costs of issuing the policy and a portion of overhead costs and hence are not available to offset future death claims as well.

Use of State Law Reserves

The first two deviations from a proper measurement of the present value of the company's future liabilities both stem from the fact that life insurance companies are allowed to compute their reserves for tax purposes on the same basis as for state regulatory purposes. State insurance regulators require that insurance companies maintain a minimum level of reserves to insure that the companies have sufficient assets to meet the claims of their policyholders. Since their task is to protect policyholders, the regulators err on the side of establishing excessive reserves. This is accomplished by using mortality tables that do not fully reflect the continuing improvement in mortality rates, and by using an interest rate well below current long-term market rates. In general, the maximum rate of interest allowed by state regulators is in the range of 4 to 5 percent.

The fact that a life insurance company may credit the policyholder with a low rate of interest comparable to that used by the state regulators in no way indicates that this is the proper discount rate to be used for computing reserves. The same may be said of an insurance policy which is priced on the basis of outdated, conservative mortality assumptions. These factors relate only to the crediting of cash to the policyholder's savings account.

We suggest that for tax purposes, the highly conservative state regulatory assumptions result in an undue acceleration of deductions. Moreover, we question whether life insurance companies should ever be allowed to compute reserves under assumptions more pessimistic than the state regulators require be used.

Net Level Premium Reserves

In computing the deduction for additions to reserves, future liabilities must be offset first by future premiums. Moreover, it is proper to take into account only net premiums.

Most cash-value policies call for gross level premiums. This does not result in net level premiums because loading charges are paid primarily out of the first year's premium. Nevertheless, the Code permits life insurance companies to compute their reserves as if they were receiving net level premiums. Thus, even though the net premium received in the first year of a policy may be very small, the company is permitted a substantial deduction for an addition to reserves. Since the loading charges themselves are currently deductible, this permits total deductions in excess of premiums received in the early years. We question the policy justification for this treatment.

Preliminary Term Reserves

State insurance regulators generally permit life insurance companies to compute their reserves on one of several preliminary term reserve methods. These methods generally acknowledge that virtually all of the first-year premium in a cash-value policy is used to pay loading and mortality charges and do not call for any significant addition to reserves in the first year of the policy.

In order to prevent companies using a preliminary term method of reserves from being disadvantaged vis-a-vis those using a net level premium method, the Code allows them to "revalue" their reserves as if they had been computed using a net level premium method. This revaluation may be done on an exact basis, in which case the company gets the same benefits as if it had been using the net level premium method, or on the basis of two approximation formulas.

We believe that the approximation formulas in the Code (even as modified by TEFRA), overstate the adjustment needed to go from preliminary term reserves to net level premium reserves. This overstatement occurs to some degree where the reserves are computed by using the classic preliminary term method, the Commissioners' Reserve Valuation Method. The amount of overstatement is significantly greater when other preliminary term methods are employed by the company in computing their reserves.

In addition, the presence of the preliminary term adjustment formulas has led many life insurance companies to sell "graded premium" life insurance policies that purportedly entitle them to extraordinary levels of deductions.13/ The Treasury plans to issue regulations in the near future that will prevent life insurance companies from using so-called graded premium policies to obtain these unintended benefits.

The original rationale for using the approximation formulas was that the smaller life insurance companies did not have the resources to make the calculations necessary to perform the exact revaluations. Given the widespread use of computers, this rationale is no longer persuasive. Moreover, any change in the method of computing reserves should not necessarily be applied to existing policies since to do so would in effect give a double deduction. Accordingly, any increased computational burden could be phased in over time.

5. Other Issues

I would like to discuss briefly a few additional issues that arise under the 1959 Act which raise serious tax policy concerns. These issues involve the various methods used by certain segments of the life insurance industry to take advantage of the differential tax treatment of income that existing law characterizes as either investment income or underwriting income and the way in which investment income is computed.

a. Consolidated Returns

Life insurance companies are permitted to join in the filing of consolidated returns. If more than one life insurance company files as part of a single group, it is necessary to determine how to consolidate the income of the life insurance company members. In proposed regulations issued by the Internal Revenue Service in 1982 (prior to the enactment of TEFRA), it was suggested that life insurance companies be required to compute their consolidated income on a "phase by phase" method of consolidation. Under this method, the investment income of the separate members was aggregated to produce a consolidated investment income.

13/ In substance, graded premium life insurance policies are term insurance policies that are renewable for up to 40 years combined with a level premium, level death benefit policy that comes into effect thereafter. The first year premium for such a policy is frequently as low as $1 per $1,000 of insurance. Life insurance companies have claimed that these are whole life policies so that they are entitled to increase their first year reserves by $19 per $1,000 of insurance protection.

Similarly, the underwriting income was determined on a consolidated basis. Only if the group of life insurance companies experienced consolidated underwriting income would the group be permitted to deduct any of the special deductions or defer (and effectively exempt) one-half of the consolidated underwriting gain.

In TEFRA, Congress decided that affiliated groups of life insurance companies must compute consolidated life insurance company taxable income by taking into account the separate taxable income or loss of the members. This provision allows one member of an affiliated group to exclude one-half of its underwriting income from taxation even if the other members of the group incur underwriting losses.

This method of consolidation encourages large insurance companies to divide their life insurance business among separate corporate entities, so that one will have substantial underwriting income and the other will have substantial tax losses. Although the entire life insurance operation would have substantial taxable income if the insurance business were conducted in a single corporate entity, the existing tax rules treat the combined operation as if it experienced significant losses.

To illustrate, a life insurance company may divide its life insurance business between itself and a subsidiary. Suppose the parent has no investment income and has underwriting income of $100; the subsidiary has a loss of $50. Under the TEFRA consolidated return rules, this group of life insurance companies would have no tax liability since only one-half of the underwriting income of $100 is subject to current tax, and it is offset by the $50 loss of the subsidiary. We understand that certain large life insurance companies are structuring their affairs to produce this result.

Although this example is simplistic, it illustrates the potential for abuse of this method of consolidation is substantial, and we seriously question whether its use should be permitted.

b. Reinsurance

Reinsurance is a contractual arrangement by which one insurance company insures risks previously insured by another insurance company. In recent years, some life insurance companies have used reinsurance to convert investment income into underwriting income and, particularly in the context of consolidated returns, to transfer income from one member to another. The incentive to engage in these types of arrangements would be eliminated if all types of income were taxed in the same manner. However, absent such a change, tax motivated reinsurance arrangements will continue to be used to take advantage of the existing rules.

c. Taxable Investment Income

The current tax rules allow a life insurance company to compute its investment income in two ways. For purposes of computing total income, a company is allowed to deduct the interest actually required to meet its contractual obligations. However, for purposes of computing investment income, the company is permitted to deduct a greater amount computed under the so-called "Menge" formula.

The following example illustrates the manner in which the formula operates. Consider a company whose life insurance reserves total $100,000. Assume further that the company realizes net investment income of $7,000 and is required to credit interest to policyholders at the rate of 4 percent. For purposes of computing total income, the company may deduct $4,000. However, for purposes of computing investment income, the deductible amount will be $4,900.[14]

Permitting this larger deduction for purposes of calculating investment income has two principal effects. First, it permits almost all mutual companies to increase the amount of deductible policyholder dividends. Second, a handful of stock life insurance companies are permitted to increase the portion of their income that is treated as underwriting income, only one-half of which is effectively subject to tax.

We question whether this method of computing investment income is justified. As we indicated earlier, the permitted level of deductions for policyholder dividends should be addressed directly in a manner that focuses on the appropriate basis for taxing a mutual business entity engaged in the life insurance business. Insofar as this provision merely permits a small group of stock life insurance companies to increase the portion of their income that is not subject to tax, we do not see any policy justification for its continued existence.

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[14] This deduction occurs under the pre-TEFRA rules. Under the temporary TEFRA rule, the deductible amount would be $5,103.

In addition, we note that the interplay of the current rules for determining taxable investment income produce certain unintended results. For example, a life insurance company that incurs interest expense may be entitled to deduct more than one dollar for each dollar of interest that it pays. Elimination of the artificial rules for computing taxable investment income would eliminate these unintended tax consequences.

C. Conclusion: Taxation of Life Insurance Companies

We have attempted to set out a conceptual framework for the tax treatment of life insurance companies. The principal features of this framework include:

- a tax base would include all economic income, with no distinction based on investment income or underwriting income;
- mutual life insurance companies would be treated as corporations with certain amounts deemed to be corporate profits;
- a full deduction would be allowed for amounts credited to policyholders other than in their capacity as stockholders;
- deduction of reserves would more accurately reflect the present value of future liabilities;
- adjustment of the effective tax rate of life insurance companies would be made through rate adjustments or comparable deductions applicable to all life insurance companies.

We recognize that many hard problems remain to be resolved and we look forward to working with the Committee and its staff in seeking solution to these problems.

Chairman STARK. Mr. Secretary, thank you very much. It is excellent testimony and I think it sets an outstanding guideline and framework for the subcommittee to work with and to follow as we listen to the testimonies of the next couple of days.

You raise a couple of points that I think I missed in my opening statement. I think it is accepted that the Federal Government in fact and in principle exercises absolutely no regulation over the life insurance industry. I am sure many of the witnesses in the next few days will refer to a definition of the life insurance product and the necessity for assuring that benefits will be payable in the future.

That is really not before this committee. The only real jurisdiction, if you will, is how to best determine the taxes that will be paid. That puts somewhat of a constraint on us in making these definitions. Indeed I will ask you later about how we determine what corporate profits ought to be as between various companies, or what is a fair amount of cash value.

We are constrained, it seems to me, to always be dealing with this through the Tax Code. If we want to, say, define universal life, which we will probably discuss later in the testimony, really all we can do is figure out a tax adjustment that tends to bring it into focus. We cannot prohibit the sale of it, for example. We cannot limit dollar amounts that are sold. We can only change the tax treatment.

Having said all that, we have a lot of options at our disposal. One that has not come up and I have not really seen in any of the testimony that I have gone through is the question of the feasibility of a premium tax. Although very simple, I am sure it has lots of problems and we will find lots of objections.

Does the Treasury have an objection or did you consider that we might just cut short the hearings and total up the revenues and go to a premium tax?

Mr. CHAPOTON. No, we have not seriously considered that, because we have addressed the problem in attempting to first analyze what the current tax system is and then to say, well, what if we move this industry into a system basically like the other companies pay. So going to a premium tax would be totally at odds with that, so we have not considered it.

Chairman STARK. Would you care to comment on the projected aggregate revenue shortfall in receipts from the life insurance industry?

Mr. CHAPOTON. Mr. Chairman, when I stated in the testimony that we have not approached this as a revenue matter, that is altogether true. I understand that estimates are coming in somewhat lower than had been projected a year ago, although the increment in revenue as a result of the changes in TEFRA are evidently about on target. That is, the base was lower than expected.

But other than that, I think I have no comment to make. Again, we are not talking about what revenue these types of changes would raise. But I would point out, as I did in the testimony, that if you move the industry on a more corporate-type system, you would overtax it in relation to other financial intermediaries.

Chairman STARK. You have mentioned in your testimony that we should compare the investment portion of insurance with other types of investments. We will also hear testimony that it ought to be compared with the equity in a home or maybe it ought to be compared with mutual funds or bank accounts.

In one of our sesions with industry leaders, a gentleman explained it to me in an interesting way; that the whole life contract is very special. He likened it to an engagement ring, which while you buy for long-term sentimental value, may indeed turn out to have some investment value.

Can you give us any guidance in how you think we should compare the investment value in life insurance to other forms of investment?

Mr. CHAPOTON. Well, the first thing to say is it is not easy. You can split it out, as we have done in our testimony, and I think the tables do it quite well. It is not hard to split out the investment portion of an insurance policy; and it is indeed easy to see what changes—and this is the important point we tried to make—what changes in the type of policy increase and how much they increase the investment orientation of a policy. So you can identify it.

And then the question we are now really talking about, at the policyholder level as opposed to the company level, we are talking about the policyholder benefit which is not now taxed or at least is now deferred. Once you identify that, what you do with it is a question that requires a good deal of thought.

We are not by any means suggesting that all of this be subjected to tax. And as we point out in the testimony, perhaps the way to address this is through the definition of the issue in the policy, because if you have a definition of insurance policy that provides the social goal that has been, we think, the justification for these favorable tax benefits, then I think you become less concerned about the tax deferral on the investment-oriented policy or the tax deferral on the investment aspect of a less investment-oriented policy.

When you move to the other type policies, you have to be more concerned about the lack of current tax on investment because it simply tells any company, whether they are a currently operating insurance company or not, that if you are going to permit that tax on earnings through anything that is called an insurance contract to be tax-deferred, then we had better get in the insurance business.

Chairman STARK. I wholeheartedly agree. Now, if you can just answer this last question, we could probably adjourn early and get busy.

You say, and I quite agree, that there should be some distinction in the policyholder dividends in mutual companies as to what part of it is a corporate profit. You refer to that in your testimony on page 25, but you stopped too soon. You did not really advise the committee on how you thought perhaps we ought to measure the "corporate profit" of a mutual life insurance company.

And I wondered if you or your associates could lead us in the path of enlightenment and equity in answering that question?

Mr. CHAPOTON. We will be happy to try. The ready answer is now, Mr. Chairman, we do not know. I think, though, it will be an approximation. It will not be impossible to calculate. If the principle is accepted, then we can come up with an approximation that I think would be fair; but it does require a good deal of study. A lot has been written on this.

Chairman STARK. We would appreciate your continued help, but with special emphasis on that area, because as I am sure you understand, that is one of the more contentious parts of the problems that we are dealing with. And I want to thank you very much for your excellent testimony again.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Thank you, Mr. Chapoton.

You indicated that insurance companies were using pessimistic mortality assumptions. Haven't many of the companies raised their mortality assumptions in the last few years?

Mr. CHAPOTON. I believe that is correct, Mr. Duncan.

Mr. DUNCAN. Well, that would not necessarily be a pessimistic assumption then if they have raised the mortality rate. That would be optimistic.

Mr. CHAPOTON. I believe it is unquestionably the case that the mortality assumptions are less favorable, are more pessimistic than the Commissioner's standard table.

Mr. DUNCAN. Regarding reinsurance, is that not used more by smaller companies or perhaps even some of the newer companies than it is by the larger companies?

Mr. CHAPOTON. Yes, I think that is correct.

Mr. DUNCAN. Now, you mentioned that loans on policies should be treated differently for tax purposes. Are you referring to new policies or all policies in existence today?

Mr. CHAPOTON. We would have to address that, but we addressed that in the pension area last year. You could do either. You could do existing policies. Probably we would talk about new policies. I think it might be considered———

Mr. DUNCAN. Because many people have invested in policies in prior years, and certainly one of the inducements was the loan value.

Mr. CHAPOTON. You understand we would not be taking away the loan value, but it would treat the event of the loan differently for tax purposes.

Mr. DUNCAN. The interest paid?

Mr. CHAPOTON. Yes.

Mr. DUNCAN. Group term insurance, is it used more by younger people?

Mr. CHAPOTON. Well, it is used by virtually all employers to protect their employees of all ages. There are, we think, as is mentioned in the statement, some problems.

Mr. DUNCAN. Young families, growing families who need coverage not so much from an investment standpoint, I think, use that.

Mr. CHAPOTON. Oh, I agree. It is not an investment aspect. The group term area is pure protection, and the problems are—it is really over in the area—we did not want to dwell on this too much—it is over in the area of employee benefits.

Mr. DUNCAN. The deferred tax that you referred to, is that pretty well evenly divided between mutuals and stock companies?

Mr. CHAPOTON. It depends on whether you are talking about now or now after December 31, 1983; that is, after the expiration of stopgap. And I think the mutual companies think that the deferral is of more benefit.

Excuse me. Let me back up. Are you talking about the deferral on policyholder earnings?

Mr. DUNCAN. Yes, sir.

Mr. CHAPOTON. No. I think—I would not offhand know that it is of benefit to one segment of the industry more than the other.

Mr. DUNCAN. Thank you, Mr. Chapoton.

Thank you, Mr. Chairman.

Chairman STARK. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Chapoton, under the 1959 act, as you pointed out, life insurance companies are allowed to revalue life insurance reserves computed on a limited term basis to net level premium reserves for tax purposes by using either an exact revaluation or an approximate revaluation.

You suggested in your testimony that that needed to be reexamined, but I wonder if you might be a little more explicit in regard to that. What is the Treasury recommending in regard to that policy, and specifically, should we continue the TEFRA formula?

Mr. CHAPOTON. Should we consider what?

Mr. FLIPPO. The TEFRA formula. I am asking you what are you specifically recommending in regard to the policy of giving those choices, and do you think we should maintain the TEFRA formula?

Mr. CHAPOTON. Well, I think the question is whether the TEFRA formula goes far enough. So we would certainly support that limitation. And beyond that, I want to look at the specific effects of dropping the adjustment, but I think basically it is an adjustment which has no basis in reality. Any company can make the computation of the exact method. So I am not sure that we are absolutely recommending that the approximation formulas be done away with. But that would be the upshot of our analysis to date certainly.

Mr. FLIPPO. One of the—I am really not sure where you came down on that.

Mr. CHAPOTON. It came down that we would do away with the approximations.

Mr. FLIPPO. Thank you.

Mr. CHAPOTON. I would caution, the problem in each of these changes is you do need to examine them and see what the effect of the changes in specific instances might be. We will need a lot of help from the industry in doing that.

Mr. FLIPPO. We have had some discussions on definitions like life insurance. Of course, the right to tax I guess is in a sense a regulation in itself, taxation. But anyway, I am interested in some definitions in some other areas as well.

For instance, we have a recommendation to broaden the definition of investment expenses. I wonder if you might tell us what is your position on this issue, and could you tell us what would be involved in accurately determining legitimate investment expenses under some expanded definition.

Mr. CHAPOTON. Our approach is that you do not separate investment income from underwriting income, so the meaning of investment expenses would not be a relevant consideration. That type of question has to be addressed if you separate the two, if you put them into two different baskets.

Mr. FLIPPO. I have no further questions, Mr. Chairman.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Chapoton, on page 13 of your testimony you describe the reasons that a definition of life insurance is now necessary for purposes of legislation; and I agree with that. I agree with the reasons that you have set out for suggesting we include in the code a definition of life insurance.

You have not given us much in the area of specifics in the definition of life insurance. Is Treasury prepared to recommend some specifics?

Mr. CHAPOTON. Yes. We are not now prepared to recommend specifics, but we will recommend a specific definition. As our examples show, it is a complex subject, and it is a value judgment, the value judgment being when a certain degree of investment orientation is too much. Some have suggested the single premium policy would be the cutoff point. We are not ready to accept that yet.

Mr. DORGAN. Well, I think this is a very important area, and I certainly share your thoughts. I would hope that we could get some specific recommendations from Treasury soon.

Mr. CHAPOTON. It is related to the question of how you treat the policies that fall on the good side of the line, as I pointed out in my testimony. And we will continue working on this, and we will make specific recommendations on the definition.

Mr. DORGAN. Also, one other question. On page 25 of your testimony—this relates to the question that the chairman asked—you talk about reconstructing definition of corporate profit on behalf of the mutuals to determine what would be appropriate to use as a measure of the nondeductible portion of the dividends.

Without having a specific approach to constructing the "corporate profit" as you describe it, can you tell us in your mind what you think the effect of that would be vis-a-vis the current approach to taxation of mutuals?

Mr. CHAPOTON. I do not know that I can answer that, because what we are talking about is giving a full deduction for policyholder dividends, which is not now allowed mutuals. So you have a more favorable treatment there.

And then you have another portion that is not in the law now that would be nondeductible—the return to equity owners—and I just could not answer that. If you are asking if whether it would be more favorable to mutuals than now, I really could not answer that. I suspect it would vary from company to company, but I do not know industrywide.

Mr. DORGAN. I am just trying to get some idea based on what you know of the tax liability of mutuals under the present law. I assume that notwithstanding the fact that you do not have a notion of what the specifics of the construction of the corporate profit would be, is that concept likely to move toward a greater tax liability for mutuals or lesser tax liability for mutuals?

Mr. CHAPOTON. I think it probably would move to somewhat greater liability for mutuals.

Mr. DORGAN. All right. I have no further questions, Mr. Chairman.

Chairman STARK. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Secretary, I want to thank you for testifying. Your testimony is an excellent discussion of the history of the tax law, how it works, what possibly ought to be done about it. Your suggestions are good food for thought for how to change the tax law.

I would follow my colleagues and ask you, if you would, to make these recommendations more specific in terms of language. The revenue results would also be appreciated. In addition, an example of how your proposal treats stock and mutual companies would be very helpful. This would let us see if we are treating them equally, or producing some aberrations that we have to take care of.

Last, Mr. Secretary, could you also furnish us with information indicating how the proposed taxation of life insurance will put these companies in comparison to other financial institutions. Specifically, do they still have a significant tax advantage, or do we have them roughly equal with other companies—whether they are stockbrokerage houses or banks—selling a similar product? The real work of this subcommittee, as I see it, is trying to come up with a specific statutory proposal and understanding the effects that proposal has, not just in raising money but between the various forms of companies in the life insurance industries, and then that group versus the rest of the economy.

We are going to need your help, and you have made a great start this morning with your testimony.

Mr. CHAPOTON. Mr. Moore, I would say, number one, between the two segments of the industry what we are outlining would clearly be designed to bring about equality. If it worked the way we think it would, there would be equality between the two segments of the industry.

We will need, and I suspect this hearing and our statement today will bring about responses from the industry which will help us answer some of the specifics and enable us to make a specific recommendation on many of the unanswered questions.

Finally, I would point out in the competition vis-a-vis the other financial institutions, as we point out, once you reconstruct actual economic income along the lines we are talking about, then you would indeed raise the question of relative tax burden. And a full corporate rate, we are convinced, would be unfairly high on the insurance industry.

Mr. MOORE. Mr. Secretary, I look forward to working with you. Thank you for what you have done.

Mr. SCHULZE. Would the gentleman yield?

Mr. MOORE. I would certainly yield.

Mr. SCHULZE. Maybe I missed it. Did you agree to provide the material?

Mr. CHAPOTON. Yes, we will provide that.

Mr. SCHULZE. And a footnote: it would be very helpful to me if you would include burden tables so we may find out what classes of citizens are going to be impacted, or were you talking about companies only?

Mr. MOORE. My request was for companies only, but I certainly have no objection to the information the gentleman is asking for.

Mr. SCHULZE. It seems to me that that would be helpful if we could get that.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. CHAPOTON. Mr. Schulze, I am advised that the burden table, which would be very helpful, we are not sure we can do that when you start talking about taxing the policyholders. It would be very instructive, I agree, but what you want to know is what income levels they are.

We might be able to get—I know the insurance companies have advised us of their feeling on those questions, and we might be able to develop some information.

Chairman **STARK.** I would just interject at this point to say that I am sure in the next several days we will ask many of the witnesses to provide additional information to us, and I would ask unanimous consent of the committee that that be submitted to the subcommittee, and we will, as immediately as we can, provide copies to all of the members and their staff.

Mr. Duncan.

Mr. DUNCAN. Mr. Chairman, do I understand that each member may submit questions in writing for each witness who will testify here today?

Chairman **STARK.** I would ask unanimous consent that each member may, at their convenience, submit questions in writing to the witnesses. If the response is directed to the subcommittee, it will be included in the committee report. And further, that any member who may have extraneous or additional material be allowed to submit it.

Mr. DUNCAN. Thank you, Mr. Chairman.

Chairman **STARK.** Mrs. Kennelly.

Mrs. KENNELLY. Thank you.

Mr. Secretary, I think there were some that wondered if you would be very specific or general this morning. I think you answered that question, and I commend you for the number of questions that you have raised.

Obviously, one of the key concerns of this committee is the extent to which insurance products have been used as tax shelters. Has Treasury performed any recent analysis of the abuses that have come about through the attempt to use these products as tax shelters? Has there been any real study done on it?

Mr. CHAPOTON. Do you mean the numbers of policies, that type of thing? We certainly have analysis of the types of policies that we would consider troublesome, yes, and abusive. We could use a very strong word on some of them. We could certainly have that analysis.

Now, I do not know if we have analysis on the dollar volumes, the number of such policies being issued, that type of thing.

Mrs. KENNELLY. Thank you.

To go back to Mr. Flippo's question, last year TEFRA attempted to define a good universal life insurance policy, one that would have the same type of tax deferral allowed traditional insurance policies. I did not quite get clear whether you think we could work with TEFRA and more or less improve what we did last year, or do you think we should eliminate what was done last year and start again on addressing abuses?

Mr. **Chapoton**. We think that the TEFRA definition is not adequate, that we should have a tighter——

Mrs. **Kennelly**. That we should begin again?

Mr. **Chapoton**. We should begin again on that question, yes.

Mrs. **Kennelly**. You mentioned in your testimony that deferred surplus accounts may be phased out, or at least there is a possibility of phasing them out. What would happen to the accounts as they stand today? How would they be treated? Has there been any thought about that?

Mr. **Chapoton**. You are talking about the deferred amounts at the company level?

Mrs. **Kennelly**. Yes.

Mr. **Chapoton**. We have given some thought to that. We have not come to a decision, but that is the type of question that we would need more input from the industry on. And we raise the question in the testimony. We do not answer the question. And I think we would like at this point to leave it in that posture and see what we hear.

Mrs. **Kennelly**. Then let me add a few more words. You did mention that you thought there were a few large stock companies that profited by this type of tax treatment. I think—and please correct me—that the figure is $9 billion that is in deferred surplus accounts. There is a possibility that some of the companies that you mention might have $4½ billion in their accounts.

Where is the other surplus? Are we going to address that? Where is the other half of that very large amount of money?

Mr. **Chapoton**. Well, I cannot answer that specifically, but it is not limited to the few large stock companies that we mentioned that have deferral of one-half of their underwriting income. There is also deferral under the so-called special deductions. We do not know the dollar figure.

We hear the $9 billion figure, too, but we do not know that that figure is accurate, and we do not know where it is.

Mrs. **Kennelly**. Well, I think there are some companies that do sell just term insurance and do not have a lot of investment income. I do not think we should just look at half of the problem. I think we should look at the other half and see if action is necessary. Credit insurance companies are what I am talking about.

Mr. **Chapoton**. I would agree.

Mrs. **Kennelly**. I think that you, sir, gave us more food for thought than we are probably going to give you at this moment.

Mr. Chairman, I thank you for allowing us not only to ask questions but to have questions submitted in writing to the witnesses.

Thank you, Mr. Chapoton.

Chairman **Stark**. Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for your statement. Let me see if I can firm up two or three things from the viewpoint of the administration.

First of all, it is my understanding that the administration will not come in and say, we need to raise *x* number of dollars from the insurance industry. Is that correct?

Mr. CHAPOTON. That is absolutely correct.

Mr. JENKINS. So as we deliberate on this issue, we can eliminate entirely from our thoughts the desirability of raising revenue.

Mr. CHAPOTON. The result may or may not be that you raise revenues, and I suspect that question is going to come up again and again. A related element here is, when stopgap expires at the end of this year revenues from the industry go up in a haphazard manner.

So while our goal is not to set out to raise revenue, none of us is going to be able to divorce ourselves from the fact that revenues, up or down, are going to be a consideration.

Mr. JENKINS. Well, the only thing I wanted to be sure about is that we often get into drafting tax changes and find out in the fourth quarter that we need to raise *x* number of dollars. We will not see that in this particular instance, is that right?

Mr. CHAPOTON. That is correct. And to State it more succinctly, I think what we will see is an attempt to examine whether the companies are properly taxed vis-a-vis their competitors in other industries and vis-a-vis the two segments of the industry. Once you arrive at where that proper tax should be, it could raise revenues, but it will not be to meet a designed target, or it could lose revenue as opposed to the expiration of stopgap.

Mr. JENKINS. We have talked briefly about tax shelters, and we would agree that there is some degree of tax shelter involved in the insurance industry. I believe you indicated that 80 percent of the households in the Nation have some form of life insurance.

Mr. CHAPOTON. I do not think I indicated that. I have heard that figure, though. I would not be at all surprised by it.

Mr. JENKINS. Would you agree that as far as tax shelters are concerned that the insurance industry is probably the most widely used tax shelter for the low income and the middle income people?

Mr. CHAPOTON. Well, I almost hate to use the words tax shelter. It is rather pejorative. But clearly, historically the tax benefits of life insurance have been widely used in small policies by low-income persons. Maybe "have used" is too strong a term. They have purchased life insurance for the protection, the risk-sharing that it gives, and they have enjoyed the tax benefits from the investment aspect of cash value life insurance that has flowed traditionally.

Mr. JENKINS. This committee has looked at municipal bonds and other tax-free debentures. Normally those are purchased by higher income people who are able to shelter a great deal of income through a variety of tax devices. It appears to me that, as we talk about tax shelters per se in the insurance industry, the middle income and the low income probably receive a greater benefit from a tax shelter standpoint than any other segment of our population.

Mr. CHAPOTON. I think I would probably agree with that. If you turn that question in terms of the rate of tax that would otherwise be paid on the deferred income in the policy, it would be a low rate of tax.

Mr. JENKINS. A very low rate overall, as a matter of fact.

But let me ask you one other thing. In reading your recommendations, you suggest that mutual life insurance companies be treated as corporations, with certain amounts deemed to be corporate profits.

Now, as I understand it, the administration has not yet come to a conclusion as to what amount would be deemed to be corporate profits, is that correct?

Mr. CHAPOTON. You can State the principle very easily, but putting a formula to determine that principle is not easy. The principle is the amount that would be considered a reasonable return on the equity portion of the policyholder's investment in the company would be deemed to be corporate profits.

Mr. JENKINS. And then you have a recommendation that the deduction for reserves should more accurately reflect the present value of future liabilities. I am assuming that you are referrring specifically to the 818(c)(2) provisions primarily?

Mr. CHAPOTON. Well, no. Referring to that, but also referring to the very basic question of the assumptions utilized by State regulators, and whether those assumptions are understandably so pessimistic that they overstate the reduction for tax purposes and therefore defer income unnecessarily.

Mr. JENKINS. The administration is not recommending, though, that we disavow the state regulatory requirements for reserves?

Mr. CHAPOTON. No, not at all. What the State regulators do is their decision, their ball game. The question, though, of whether we should accept those for tax purposes can be raised legitimately, and we are raising that question. And there are cases where the companies take an even more conservative approach than required by the state regulators, and we seriously question that.

Mr. JENKINS. Let me ask one specific question on 818(c)(2) provisions. As I understand it, the smaller stock companies are the primary beneficiaries of the 818(c)(2) provisions.

Mr. CHAPOTON. I think historically that probably was true, and the logic of it was for the smaller companies. There is some question as to whether it is true today. I think it is used across the board by companies of all sizes.

Mr. JENKINS. If we drastically change the provisions of 818(c)(2), and I believe they were recently changed from a high of 21 down to 19; is that correct?

Mr. CHAPOTON. In TEFRA, yes, sir.

Mr. JENKINS. If we change that section of the law, then where would the smaller or newer companies be from a competitive standpoint in relation to the larger companies that have the bulk of the assets and the bulk of the business?

Mr. CHAPOTON. I do not think it would change the competitive standpoint. It might—as in any industry, the larger companies have certain advantages, and those advantages would exist in this industry. But on an individual analysis of one company from the largest to the smallest, I do not see that the competitive situation would be affected by this change.

They can make the computation, which was an argument earlier. I think there is no question they can make the computation by the exact method, and therefore, other than the general consideration of small companies may have problems that large companies do not have, I do not think that this aspect of it causes any problem.

We in the tax law see benefits for small business of all types. I would question whether you ought to do it through this sort of method, that defies full analysis of exactly what is being done, however.

Mr. JENKINS. Then the administration would agree that we ought to look at some aspects of the tax law as it relates to small insurance companies?

Mr. CHAPOTON. We certainly always do. We look at smaller companies in all industries to see if you ought to tilt a competitive balance through the tax laws. Often we disagree with that result, but I think it is given that that examination is usually made.

Mr. JENKINS. In that same vein, of the some 2,000 insurance companies, what percentage of the business is lodged in the top 10 or 15 percent?

Mr. CHAPOTON. A very large percentage. Let me see if I have that.

We have to supply that, Mr. Jenkins. I do not have it.

Mr. JENKINS. But the 1,900 smallest companies have a very small part of the business, is that correct?

Mr. CHAPOTON. That is correct.

Mr. JENKINS. Thank you, Mr. Chairman.

[Additional information follows:]

Percentage of Assets Controlled by Largest Life Insurance Companies in 1981

Group:	*Percentage of assets controlled*
Largest 10	51.3
Largest 15	59.1
Largest 20	63.2
Largest 100	84.7

Chairman STARK. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. Secretary, I also would like to thank you for your testimony, which in my opinion has been long on generalities and sort of short on specifics, but perhaps of necessity at this stage of our deliberations. And I am pleased that you have offered to work closely with the committee in the ensuing deliberations. We will need your assistance, Buck.

I guess the bottom line of your testimony is that you conclude that changes should be made.

Mr. CHAPOTON. That is correct, and I should emphasize that again and again, because that is the basic point that should be made. We think a change is required, and I would agree with the chairman that it would certainly be desirable and maybe mandatory that the change be made this year.

Mr. SCHULZE. Now, I just made some notes while you were testifying. Is your major concern with the structure of present taxation, the structure of the tax, the amount of tax paid, whether the social goals are being met, or the competitiveness with other businesses, either savings and/or other industries?

Mr. CHAPOTON. I am tempted to say all of the above, except the revenue constraints. But looking at it from two standpoints, one is from the company side and it is clearly the structure. Clearly, the structure of taxation and this difficult problem where we have two types of players in this system—and the adjustments that have been made in the prior act because of that fact—have resulted in a structure that I think I would describe as simply not working, at least not working correctly.

So you change that structure to bring about an even playing field between the two, stocks and the mutuals, and a structure that is more easily understood, and a structure that would also bring about a fair situation versus other noninsurance financial intermediaries with whom the insurance industry competes.

If you turn to the policyholder side, you are immediately confronted with what at one end of the spectrum is I think clearly an abuse, that is products which masquerade under the name of an insurance policy but are, in fact, an investment vehicle for the purpose of obtaining the deferral of tax available for life insurance.

You move from there to the basic question of the tax deferral on earnings through insurance generally, and then you get to more difficult questions, because you have a lot of policy considerations that speak in favor of tax benefits for life insurance. So I think you can come to the point that you want to keep these favorable benefits for some types of policies, and you have got to decide where that line should be drawn.

Mr. **Schulze**. You would recommend that we do keep in mind the social goals for the very existence of the insurance industry?

Mr. **Chapoton**. That is correct, we very definitely would keep that in mind. It will be an important factor in our consideration of the changes, and I know it will of the subcommittee as well.

Mr. **Schulze**. Along that line, do you have figures or can you make available to the committee figures on the overall number of people employed in the insurance industry, including sales and service?

Mr. **Chapoton**. I am sure the industry has such figures and we would be happy to obtain them and send them to the committee.

Mr. **Schulze**. As well as total taxation, including individual income tax and State and local taxes, so that we can get an accurate figure of the overall burden and/or contribution to the overall society that the industry makes.

Mr. **Chapoton**. We can get you figures on the Federal taxes paid by the companies.

[Additional information follows:]

According to industry figures, the total number of people employed in the insurance industry in 1981 was approximately 1,905,000. This number includes individuals employed in life insurance as well as other branches of insurance.

TAX LIABILITY OF LIFE INSURANCE COMPANIES

[In millions of dollars]

	Calendar years						Projections	
	1975	1976	1977	1978	1979	1980	1984 [1]	1984 [2]
Tax liability:								
Stock	609	691	853	1,088	1,192	1,068	1,416	1,278
Mutual and other	1,175	1,309	1,410	1,682	1,786	1,033	2,432	1,574
Total	1,784	2,000	2,263	2,770	2,978	2,101	3,848	2,853

[1] Present law with expiration of safety net provisions.

[2] Life insurance tax provisions in H.R. 4170.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 26, 1983.

Mr. SCHULZE. Can we get some even estimates of the other?

Mr. CHAPOTON. As in many of these cases, I think the industry probably has some estimates on State and local taxes paid, and we would be happy to review that.

Mr. SCHULZE. That would be most helpful.

Very briefly, on the topic of the actuarial tables being on the conservative side for State purposes and that being reflected in the amount of Federal taxation is that also reflected in policyholder charges, or are different actuarial tables used?

Mr. CHAPOTON. Not necessarily. It can be, but not necessarily. In fact, in some cases it is just the opposite. Mortality assumptions, for example. They might be different mortality assumptions, and different interest assumptions as well.

Mr. SCHULZE. Would you recommend that we somehow tie those in?

Mr. CHAPOTON. Well, we are not recommending at this point a tie-in. We must recognize and we are pointing out that the State regulators come at this from a different approach. We see that all the time in the accounting field. The accounting profession computes income conservatively and that is why you simply cannot accept the accounting definition of income for tax purposes.

They have a different goal. We think that different goal causes us to reexamine whether the State regulators' requirement of reserves is appropriate for tax purposes. It has been used a long time and so it should not lightly be dismissed.

Mr. SCHULZE. That also gives me some concern, because I have seen banks fail. We do not want to create a rash of failures in the insurance industry. I would much rather see us be a little more conservative and have a stable industry, than for us to build in a degree of instability.

Mr. CHAPOTON. We certainly would not want to build in a degree of instability, although that question is totally a question for the regulators. The question of whether taxes are unduly deferred I think is our question.

Mr. SCHULZE. I thank you, Mr. Secretary.

Mr. GUARINI [presiding]. Thank you, Buck, for a very credible performance.

Yes, go ahead.

Mrs. KENNELLY. One quick question, Mr. Secretary. We recognize that insurance is a unique industry which has been treated uniquely because of its nature. Have you any timeframe in mind for this committee to carry out the charges about which you have spoken.

Mr. CHAPOTON. Well, the time is short, because as I have stated I think action is needed this year, and we are going to continue to devote a lot of resources. We have already devoted a lot of resources to this question. We will continue to do so.

We will now rely upon and need the help of the industry. But I cannot be more specific other than to say that we both, the committee staff and the Treasury, should continue to work on this as hard as we have done, because it is going to be difficult to get this done this year.

Mrs. **Kennelly**. Would the bottom line of your testimony be that you prefer us to tax the insurance industry as other corporations are taxed?

Mr. **Chapoton**. That is correct.

Mrs. **Kennelly**. Thank you, sir, very much.

Mr. **Guarini**. Buck, there is very little time left and I do not want you to have to wait until I come back from voting. But you have put a great deal on the plate. The question is how to retain the competitive balance between the stocks and mutuals and at the same time have a just, fair and equitable tax law.

You do not want to go back to the 1959 act, is that correct?

Mr. **Chapoton**. That is correct.

Mr. **Guarini**. And you do not want an extension of stopgap, is that correct?

Mr. **Chapoton**. That is correct.

Mr. **Guarini**. You do not want this to be part of the budget considerations for this year, do you?

Mr. **Chapoton**. No, we do not. That is a good point.

Mr. **Guarini**. The question about consolidation brings up some inequities in corporations having benefits if they are insurance companies as compared to other noninsurance companies or corporations, where we have now a period of—you touched on it—consolidated balance sheets, where insurance companies are acquiring banks and investment companies and real estate corporations, et cetera.

Would you state whether or not there are any recommendations that you would like to make? Is there an inequity here in your mind and should this be addressed in this bill?

Mr. **Chapoton**. Absolutely. We think it is incorrect. We think the TEFRA provision which allows the consolidation of companies that separately state their insurance income is incorrect.

Mr. **Guarini**. And is there a loss of potential revenue to the Treasury as a result of that?

Mr. **Chapoton**. There would clearly be a revenue loss, and I do not have a figure available. We could give you a figure on that, though.

Mr. **Guarini**. Will you be working with the committee and making recommendations in this direction?

Mr. **Chapoton**. Yes, we can make a recommendation and have in TEFRA, and would renew it now, yes, sir.

Mr. **Guarini**. Do you feel that there is any question of risk on the part of the policyowners when insurance companies are able to consolidate and purchase other companies and get into side businesses? Is there any question there in your mind?

Mr. **Chapoton**. Mr. Guarini, I am really addressing the question of where two insurance companies consolidate. When you talk about consolidation with other businesses, I am not really addressing that. The problem I am talking about does not occur then and I would not have an opinion whether there is——

Mr. **Guarini**. You do not intend to address yourself to any recommendation as to how much acquisition insurance companies could make, as much as they do have insurance tax exemptions that other corporations do not enjoy?

Mr. **Chapoton**. There is a tax feature involved in that. They do acquire a tax base against which they can use some insurance benefits. That is a tax concern. Beyond that, I would not address it.

Mr. **Guarini**. In your mind, should there also in the new considerations be given a tax break between the large stock companies and the smaller stock companies, where we allow them to revaluate the reserves?

Mr. **Chapoton**. That question has been raised. We discussed it earlier. Our first preference would be no such benefit. As I said, the argument is often made that——

Mr. **Guarini**. We allowed it in stopgap last time.

Mr. **Chapoton**. Yes, and you need special benefits for smaller companies. We will hear that argument now and we will examine that argument. But our predisposition is not to give a special benefit according to the size of the company in the industry.

Mr. **Guarini**. Thank you very much.

Chairman **Stark**. Buck, if I can beg your indulgence for just a couple more questions. Do you have figures, either at your fingertips or available to you, on how many life insurance companies pay no taxes? And then do you have them categorized by those who may pay a couple of percent or very small amounts?

I notice a lot of heads nodding negatively.

Mr. **Chapoton**. No, Mr. Chairman, we do not have that information. One of the problems is, when we try to determine what percent of income is being paid in tax, it is very difficult to determine income.

Chairman **Stark**. It is easy to determine if they pay no tax.

Mr. **Chapoton**. It is easy to determine if they pay no tax. We do not have that information readily available.

Chairman **Stark**. It is my understanding in the original budget the rules required that the budget include the $4.7 billion that we estimated last year on the expiration of stopgap, but OMB just submitted a revision of the President's 1984 budget.

Do you know what figure was in that budget in terms of——

Mr. **Chapoton**. Mr. Stark, I am sorry, I do not know that. We can certainly get it for you.

Chairman **Stark**. It has been a matter of general concern and interest.

Mr. **Chapoton**. That is easily obtained and I can certainly supply that.

Chairman **Stark**. For the figures you took, did they adjust for the shortfall we actually achieved?

Mr. **Chapoton**. We do adjust receipts by conditions, so if our revenue estimators in calculating total receipts—and now we are talking about total receipts of the Federal Government in a particular industry—because of conditions that were not anticipated, we would adjust those receipts downward.

Chairman **Stark**. I have no further questions.

I wanted to thank you and your staff very much. They have been extremely patient and helpful. We have had some expertise loaned to us from your department that has been most useful. And I think that if we can continue to work together over the several months ahead that we will be able to devise a structure that will be an improvement over what we have. I appreciate very much your testimony.

Mr. CHAPOTON. Thank you, Mr. Chairman. We look forward to working with you, and we certainly hope we can move forward on this rapidly also.

Chairman STARK. Thank you very much.

Our next witness is Mr. Arthur J. Corazzini, the Deputy Director of the Program Analysis Division of the General Accounting Office, who is accompanied by Craig Simmons, the Acting Associate Director, and Mr. Natwar Gandhi, the Senior Evaluator.

Gentlemen, welcome to the committee. Again, I want to commend GAO and its staff for the help and corroboration and long hours that you have given to the members of this subcommittee and to our various staff assistants. Your help has been invaluable. I look forward to having your testimony summarized this morning.

Mr. Corazzini, you may proceed to do that in any fashion you so desire.

STATEMENT OF ARTHUR J. CORAZZINI, DEPUTY DIRECTOR, PROGRAM ANALYSIS DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY CRAIG SIMMONS, ACTING ASSOCIATE DIRECTOR, AND NATWAR GANDHI, SENIOR EVALUATOR

Mr. CORAZZINI. Thank you, Mr. Chairman.

I would like to quickly go through our written testimony, and then we would of course be happy to answer any questions you may put to us.

We are pleased to be here today to give you our views on some facets of taxation of the life insurance industry. Our 1981 report on this subject recommended some specific changes in the Life Insurance Company Income Tax Act of 1959 which we found to be seriously in need of revision.

Since then, changes in the tax treatment of the industry were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, but many of the provisions included in the stopgap legislation will expire at the end of this year.

We hope that our comments today will contribute to your important task of arriving at suitable permanent tax legislation for the industry.

Since the passage of the 1959 act, changing economic conditions, most notably inflation and its effect on interest rates, have raised doubts about the appropriateness of certain provisions of the act. The insurance companies used various provisions in the law to reduce what they believed to be unduly burdensome taxes. Most notably among the avenues of relief found was the increasing use of modified coinsurance arrangements under section 820 of the Internal Revenue Code.

The stopgap provisions of TEFRA included the repeal of section 820. Taxes paid under the new provisions are higher than what would have been paid if modified coinsurance were allowed to continue. However, tax revenues under the stopgap provisions are much lower than they would have been under the provisions of the 1959 act before the widespread use of modified coinsurance. For this reason, as well as the imminent expiration of the stopgap provisions, a reexamination of the issues is now needed.

The factor most influencing the taxation of the insurance industry is the share of investment income which should be accorded tax-free treatment. As a followup on our earlier work, we have studied the effect of the stopgap provisions as well as other proposed methods of taxation of investment income.

Our ongoing analysis has been limited to the 10 largest mutual companies and the 10 largest stock companies in 1978 and 1979. While this appears to be a small sample, these companies hold more than 60 percent of the assets of the industry.

The results we have developed to date are shown in the tables accompanying my statement, and I would like to share them with you. Referring to table 1, we found that under the 1959 act about 75 percent of investment income escaped taxation in 1978 and in 1979. Modified coinsurance was not widely used in those years.

Had the stopgap provisions been in effect at that time, we estimate that over 80 percent of investment income would not have been taxed.

Turning to table 2, the additional tax collected in 1978 under the 1959 act for our sample of companies was about $534 million more than would have been collected under the 1982 stopgap provisions. For 1979, the additional taxes from the 1959 act as compared with the 1982 stopgap were $571 million.

We have also estimated the additional taxes that would result from taxation methods other than those contained in the 1982 stopgap provisions. In our 1981 report we calculated tax liabilities of a much larger sample, the 42 largest companies, using two alternative reserve deduction methods. These methods were a policy reserve deduction at an assumed rate averaging 3 percent, and a reserve deduction at 4½ percent—the maximum assumed rate allowed in most States.

For the current sample, the 4.5-percent method would have raised $723 million more in taxes in 1978 than the 1982 stopgap provisions. This represents a 61-percent increase. For 1979 the comparable figure is $726 million, or 80 percent more. These results can be found in table 3.

In table 4 we see that for 1978, if the 3-percent assumed rate had been used for the policyholder's reserve deduction, there would have been about $1.2 billion more taxes than would have been collected under the 1982 stopgap.

The taxes under the assumed interest rate basis would have been almost double those under the 1982 stopgap provisions. For 1979 the taxes raised under this method would have been more than doubled.

I have one or two additional statements.

The 1959 act allows for a special deduction for group life and accident and health lines of business. Our current analysis of 20 large companies involved in group business indicates that over the 4 years, 1978 to 1981, only 1 company experienced a loss in the group life line. For the accident and health line of business, the 20 companies in our sample experienced a net loss, but the experience was not uniform. While all but 1 of the 10 largest mutual companies showed a loss, the reverse was true for stock companies.

Based on these results, we believe that the deduction for the group life line of business should be reconsidered.

With regard to section 818(c), the preliminary term reserve reevaluation section of the act, our 1981 report recommended changes to the basis for approximate reevaluation of reserves, and that the 1982 stopgap provisions in part followed our recommendations.

We reiterate our previous recommendation that changes need to be made in this section. With the recent proliferation of graded premium policies, our current thinking is that section 818(c)(2), providing for approximate reevaluation, should be repealed and that only exact reevaluation is appropriate.

I would also like to reiterate our 1981 report recommendation that in light of changed conditions over the years, the deferral of one-half of underwriting gains currently allowed in the law should be phased out.

I have one final comment. Conceptually we agree with proposals to unbundle insurance contracts into their investment and underwriting components for purposes of taxation. However, because of the variance from year to year in the rate assumptions used by the companies and the very large number of different types of policies still in force, there is a question as to how dividends to policyholders can be separated into the true excess interest portion and the underwriting gain portion.

We feel this type of proposal deserves more careful attention. We are willing to assist this committee in any way we can.

That does conclude my formal statement, Mr. Chairman, and we would be happy to answer your questions.

[The tables referred to follow:]

Table 1

Percentage of Investment Income Not Taxed of the 10 Largest Mutuals and 10 Largest Stocks

	Stock	Mutual	Total
	1978		
Stopgap	74.9%	82.9%	80.9%
1959 Act	72.9	73.7	73.5
4.5%	71.1	70.9	71.0
Assumed Rate	67.8	63.6	64.6
	1979*		
Stopgap	81.9%	85.3%	84.6%
1959 Act	78.3	74.9	75.6
4.5%	77.1	72.0	73.1
Assumed Rate	74.2	65.9	67.7

Table 2

A Comparison of Taxes in 1978 and 1979 Between the 1959 Act and 1982 Stopgap

($000,000 omitted)

	(1) 1959 Act	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
	1978			
10 Mutual	$1,283.3	$ 782.8	$500.5	163.9%
10 Stock	434.6	401.1	33.5	108.4
Total	$1,717.9	$1,183.9	$534.0	145.1%
	1979*			
8 Mutual	$1,230.7	$710.9	$519.8	173.1%
6 Stock	286.1	234.6	51.5	122.0
Total	$1,516.8	$945.5	$571.3	160.4%

*Figures for all 20 companies were not available for this year (8 of 10 mutual companies and 6 of 10 stock companies were available).

Table 3

A Comparison of Taxes in 1978 and 1979 Between the 4.5% Method and the 1982 Stopgap

($000,000 omitted)

	(1) 4.5% Method	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
1978				
10 Mutual	$1,438.9	$ 782.8	$656.1	183.8%
10 Stock	468.2	401.1	67.1	116.7
Total	$1,907.1	$1,183.9	$723.2	161.1%
1979*				
7 Mutual	$1,336.0	$677.8	$658.2	197.1%
6 Stock	302.2	234.6	67.6	128.8
Total	$1,638.2	$912.4	$725.8	179.5%

*Figures for all 20 companies were not available for this year (7 of 10 mutual companies and 6 of 10 stock companies were available).

Table 4

A Comparison of Taxes in 1978 and 1979 Between the Assumed Rate Method and the 1982 Stopgap

($000,000 omitted)

	(1) Assumed Rate Method	(2) 1982 Stopgap	(3) Excess of (1) over (2)	(4) Ratio of (1) over (2)
1978				
10 Mutual	$1,838.0	$ 782.8	$1,055.2	234.8%
10 Stock	522.5	401.1	121.4	130.3
Total	$2,360.5	$1,183.9	$1,176.6	199.4%
1979*				
7 Mutual	$1,640.2	$677.8	$ 962.4	242.0%
6 Stock	343.7	234.6	109.1	146.5
Total	$1,983.9	$912.4	$1,071.5	217.4%

*Figures for all 20 companies were not available for this year (7 of 10 mutual companies and 6 of 10 stock companies were available).

Chairman STARK. Mr. Corazzini, thank you.

I have a couple of questions.

The Secretary has suggested that as between stocks and mutuals, we impute a certain amount of the policyholder dividend, impute that to be a return on equity or impute it to be somewhat similar to a stockholder's dividend.

Do you have or do your associates have any recommendations as to a method or procedure for calculating that? Have you looked into that area in trying to ascertain how to level that playing field between stocks and mutuals?

Mr. CORAZZINI. Well, let me say a couple of things. One, we have not looked into it in detail. I think that the Secretary's comments with respect to the theoretical issues involved were quite extensive in this regard, and that we would tend to agree that there would be types of policies where there would be large elements of investment income involved and that that is a concern from the tax side.

We also would tend to agree that the task of separating the two components is relatively straightforward. What you do with the two components afterwards is another matter.

One of my colleagues may want to add to that.

Mr. GANDHI. I think the separation of the two components has been accomplished by issuance of universal life by many companies. And if the committee wants us to help in that regard, obviously we will do that.

Chairman STARK. You have collected a good bit of data, probably more than anyone outside of the industry on life insurance companies; and again, the Treasury's testimony would indicate that there would be an empirical method to calculate some kind of deduction.

Do you think that you have sufficient data or that sufficient data exists for us to get a calculation as between stocks and mutuals?

Mr. CORAZZINI. I would want to get back to you on that, Mr. Chairman. The data base that we have does not contain 1982 and 1981 information, and there is a data collection problem for the kind of comprehensive analysis I think you are looking for. I think it is possible we could do it. I would want to think about it.

[No further information was supplied.]

Chairman STARK. In your illustrations was there anything unique about 1978 and 1979 when you compared the investment income shelter?

Mr. CORAZZINI. In those comparisons we picked 2 recent years for which we had relatively complete data. Second, they are 2 years in which the extent of usage of modified coinsurance—where there was not extensive use of modified coinsurance, so in that sense those years are important.

Chairman STARK. In your suggestions for eliminating special deductions for group life and possibly retaining those deductions for accident and health, you were silent about the deduction for nonparticipating policies. Do you have any recommendation on that?

Mr. CORAZZINI. We do not have a recommendation. Again, I would turn to my colleagues for additional comments.

Mr. SIMMONS. I believe we found that that was not a terribly important issue, at least in the terms of the tax consequences are concerned. I will defer to Mr. Gandhi if he would like to add some details.

Mr. **Gandhi**. The order in which that deduction is taken, the nonparticipating deduction is the last one. Consequently, in our sample we found only 5 among the 10 largest stock companies using that particular deduction. And as Mr. Simmons pointed out, as of now we are yet not sure about the tax consequences.

Chairman **Stark**. Mr. Duncan.

Mr. **Duncan**. I have no questions. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Moore.

Mr. **Moore**. Mr. Chairman, I was absent during the delivery of the testimony, but I did read it prior to delivery of it. As far as your report goes, it is good. However, we are talking about going further in the subcommittee than your report addresses.

Do you think it is possible that before we complete markup you would have additional comments or information to assist us in going further with our reconsideration of the 1959 act than you have done in your report?

Mr. **Corazzini**. Absolutely, Mr. Moore.

Mr. **Moore**. I look forward to receiving that.

Thank you for being with us today.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you.

Gentlemen, I appreciate the work you have done, and I would join with Mr. Moore in saying that we would look forward to your continuing your tradition of very excellent analysis and interpretation of the data for this committee and its staff. The brevity of your testimony only adds to the distinction of the panel before us. We appreciate it very much.

Thank you.

Mr. **Corazzini**. Thank you, Mr. Chairman.

Chairman **Stark**. Our next group of witnesses is a panel comprised of Mr. Joseph M. Belth, the editor of The Insurance Forum and professor of insurance at the School of Business of Indiana University; Ms. Norma L. Nielson, assistant professor of insurance of the University of Southern California School of Business Administration; and Mr. Henry Aaron, a senior fellow with the Brookings Institution.

If you would all come forward.

I am going to ask unanimous consent of the witness panel and my distinguished colleagues in the minority for the chairman to indulge himself in a little bit of lunch as we proceed, and I promise not to chew so audibly as to disturb anybody. I will turn my mike off.

If you will indulge me as we work through lunch, I look forward to your testimony. Professor Belth will be the leadoff witness of the panel.

STATEMENT OF JOSEPH M. BELTH, PH. D., PROFESSOR OF INSURANCE, SCHOOL OF BUSINESS, INDIANA UNIVERSITY, AND EDITOR OF THE INSURANCE FORUM

Mr. **Belth**. Mr. Chairman, and other members of the subcommittee, I am Joseph M. Belth, professor of insurance in the School of Business at Indiana University. I am not being compensated for the preparation of this statement. The views expressed in this statement are my own and not necessarily those of any institution, organization, or other individual.

I would like to express my appreciation for the invitation to present my views at this hearing.

Since the beginning of Federal income taxation in the United States, the taxation of life insurance has favored cash value life insurance. At the company level there has been the reserve interest exclusion under which the life insurance companies have been allowed to exclude from taxable income that portion of their investment income needed to support their reserve liabilities. At the consumer level there has been the deferment and at least partial exclusion of the interest component of cash value life insurance.

I believe that life insurance serves two social purposes. One is the death protection function through which financial protection is provided to survivors of persons who die prematurely. The other is the financial intermediation function through which the savings of individuals and businesses are channeled into capital investment. Both functions are important, but the death protection function is the unique province of the life insurance industry.

It seems to me, however, that the thrust of Federal tax policy has been to favor the financial intermediation function of life insurance rather than the death protection function. I believe the most important adverse consequence of such tax policy is its contribution to the underinsurance of the American people.

To the extent that Federal tax policy favors the financial intermediation function of life insurance, companies are encouraged to design policies that emphasize the savings component and to structure agent compensation systems so as to encourage the sale of savings-heavy life insurance plans.

To the extent that the available life insurance premium dollars of consumers are channeled into the savings component, consumers are unable to purchase death protection in the amounts necessary to protect their survivors adequately. It is my belief that most Americans are underinsured and that Federal tax policy is at least partially responsible for the situation.

I believe it would be possible to develop a system of life insurance taxation that would encourage companies to put greater emphasis than they do today on the sale of death protection, and that would encourage consumers to purchase greater amounts of death protection.

At the company level the reserve interest exclusion might be abolished, but instead the companies might be allowed to deduct amounts credited to the cash value accounts of policyholders, to deduct the interest component of dividends paid to policyholders, and to deduct the protection component of payments to beneficiaries.

As an encouragement to emphasize the sale of death protection, the companies might be allowed to exclude from their income at least a portion of the protection component of premiums paid by policyholders, with appropriate adjustments for the mortality component of dividends paid to policyholders.

At the consumer level the interest credited to the savings component, including the interest component of dividends, might be taxed currently, although consideration might be given to allowing the policyholder to exclude, say, the first $500 of such interest. As an encouragement for consumers to purchase death protection, policyholders might be allowed to deduct at least a portion of the protection component of premiums paid, with appropriate adjustments for the mortality component of dividends, although consideration might be given to placing a ceiling on the amount a policyholder would be permitted to deduct.

In conclusion, I believe that Federal tax policy has consistently favored the financial intermediation function of life insurance and that consideration should be given to a fundamental alteration in that policy. I believe a system of life insurance taxation can be developed so as to expand the utilization of death protection in the private sector of our economy.

Thank you again for inviting me to present my views at this hearing.

[The prepared statement follows:]

Statement of Joseph M. Belth

Mr. Chairman, I am Joseph M. Belth, professor of insurance, School of Business, Indiana University (Bloomington). I am editor of The Insurance Forum, a four-page monthly periodical. I am author of Life Insurance: A Consumer's Handbook (1973) and various other books and articles on life insurance. I am a past president of the American Risk and Insurance Association, an organization of insurance professors and others interested in insurance education. I am not being compensated for the preparation of this statement. The views expressed in the statement are my own and not necessarily those of any institution, organization, or other individual. I would like to express my appreciation for the invitation to present my views at this hearing.

MY VIEWS ON LIFE INSURANCE

At the outset, Mr. Chairman, it seems appropriate for me to express my views on certain life insurance topics so that you will be aware of any attitudes that might influence my approach to the subject of life insurance taxation.

(1) For many years I have argued that it is appropriate for the policyholder to consider cash-value life insurance as consisting of a protection component and a savings component. The savings component is the cash value, which is logically viewed by the policyholder as an asset. The protection component is the excess of the amount payable on death over the cash value.

(2) For many years I have argued in favor of requirements for rigorous disclosure to life insurance consumers. Among the elements of a system of rigorous disclosure are the amount of the protection component, information about the price of the protection component, the amount of the savings component, and information about the rate of return on the savings component. In my opinion, the only disclosure requirements in effect today constitute pseudo disclosure.

(3) For many years I have argued against deceptive sales practices in the life insurance business. Some of the practices I have identified are today generally considered unacceptable practices, but others continue to flourish in the life insurance marketplace.

(4) I have always been neutral on the question of term versus cash-value life insurance. Term insurance has its place. Cash-value insurance has its place. It all depends on the circumstances and objectives of the consumer. I have criticized deceptive sales practices employed by advocates of term insurance, and I have criticized deceptive sales practices employed by advocates of cash-value insurance.

(5) I have always believed that life insurance is sold rather than bought, and that there is no substitute for the face-to-face meeting between life insurance agent and prospect. I spent five years as a life insurance agent in the 1950's and came away from that experience convinced that the agent plays an indispensable role in persuading the prospect to discuss the financial consequences of death, and in persuading the prospect not to procrastinate in the purchase of life insurance protection.

BACKGROUND ON LIFE INSURANCE TAXATION

Since the beginning of federal income taxaton in the United States, the taxation of life insurance has favored cash-value life insurance. At the company level, there has been the reserve interest exclusion, under which the life insurance companies have been allowed to exclude from taxable income that portion of their investment income needed to support their reserve liabilities. At the consumer level, there has been the deferment and at least partial exclusion of the interest component of cash-value life insurance.

At this point I would like to mention the exclusion of death proceeds of life insurance from the taxable income of the beneficiary. I do not regard this provision as particularly favorable to life insurance; rather, I regard it as consistent with the treatment of appreciated property generally, under which the property receives a stepped-up basis at the death of the property owner.

I believe that life insurance serves two social purposes: (1) the death protection function, through which financial protection is provided to survivors of persons who die prematurely; and (2) the financial intermediation function, through which the savings of individuals and businesses are channeled into capital investment. Both functions are important, but the death protection function is the unique province of the life insurance industry.

It seems to me, however, that the thrust of federal tax policy has been to favor the financial intermediation function of life insurance rather than the death protection function. I believe the most important adverse consequence of such tax policy is its contribution to the underinsurance of the American people.

I would like to elaborate on this point. To the extent that federal tax policy favors the financial intermediation function of life insurance, companies are encouraged to design policies that emphasize the savings component, and to structure agent compensation systems so as to encourage the sale of savings-heavy life insurance plans. To the extent that the available life insurance premium dollars of consumers are channeled into the savings component, consumers are unable to purchase death protection in the amounts necessary to protect their survivors adequately. It is my belief that most Americans are underinsured, and that federal tax policy is at least partially responsible for the situation.

A PROPOSAL

I believe it would be possible to develop a system of life insurance taxation that would encourage companies to put greater emphasis than they do today on the sale of death protection, and that would encourage consumers to purchase greater amounts of death protection. Such a system might have certain major characteristics at the company level, and certain major characteristics at the consumer level.

At the company level, the reserve interest exclusion might be abolished, but instead the companies might be allowed to deduct amounts credited to the cash-value accounts of policyholders, to deduct the interest component of dividends paid to policyholders, and to deduct the protection component of payments to beneficiaries. As an encouragement to emphasize the sale of death protection, the companies might be allowed to exclude from their income at least a portion of the protection component of premiums paid by policyholders, with appropriate adjustments for the mortality component of dividends paid to policyholders.

At the consumer level, the interest credited to the savings component, including the interest component of dividends, might be taxed currently, although consideration might be given to allowing the policyholder to exclude, say, the first $500 of such interest. As an encouragement for consumers to purchase death protection, policyholders might be allowed to deduct at least a portion fo the protection component of premiums paid, with appropriate adjustments for the mortality component of dividends, although consideration might be given to placing a ceiling on the amount a policyholder would be permitted to deduct.

CONCLUSION

Mr. Chairman, I believe that federal tax policy has consistently favored the financial intermediation function of life insurance, and that consideration should be given to a fundamental alteration in that policy. I believe a system of life insurance taxation can be developed so as to expand the utilization of death protection in the private sector of our economy.

Thank you again for inviting me to present my views at this hearing.

Mr. **FLIPPO** [presiding]. Thank you very much.

Now, we might have testimony from Dr. Nielson.

STATEMENT OF NORMA L. NIELSON, PH.D., ASSISTANT PROFESSOR OF INSURANCE, UNIVERSITY OF SOUTHERN CALIFORNIA, SCHOOL OF BUSINESS ADMINISTRATION

Ms. **Nielson**. Good afternoon. My name is Norma Nielson.

With a minimum of background I am going to move directly into specific recommendations that I deleveloped in my written testimony and summarize them.

First, I feel that the basis for taxation of the industry should be gains from operations calculated using statutory figures. The companies are required to use the conservative mortality and interest assumptions by the States which regulate them in most aspects, and calculation of deductions on any other basis is not particularly fair.

The law should then allow other special adjustments such as depreciation and so forth that are not used in statutory calculations. This figure should specifically allow tax-exempt treatment on municipal bonds and other items that receive tax-exempt treatment by any other taxpayer and a full deduction for premium taxes paid to the various States.

This is particularly important in maintaining the competitiveness between the life insurance industry and other financial institutions, a concern several members have expressed here today.

In Mr. Stark's home State of California, for instance, the State premium tax on gross income exceeds the estimated effective tax rate of commercial banks at the Federal level.

Deductions for reserves should be on an exact basis using some specified method such as the so-called CRVM, commissioner's reserve valuation method, with special transition considerations for previously deferred taxes.

The $19 preliminary term adjustment currently allowed—and on this point I agree with Mr. Chapoton—has been outdated by computer development and so forth and can be gradually reduced and eliminated.

Dividends to policyowners should be fully deductible to the companies, and to reverse Mr. Chapoton's order, these are first and foremost a rebate on an amount that the company overcharged in its initial calculation in the interest of conservatism. They are not a deductible item to the policy owner and therefore are not taxed at that level.

I have examined 1,661 life insurance company balance sheets to determine whether or not the equity portion of dividend payments by mutual companies is a significant concern, and my conclusion is that it is not. Going in with the premise that a decrease in the surplus being held by the company would constitute a return either of the policyholder's equity or on the policyholder's equity, of those 1,600-plus companies I found exactly 8 mutual companies which experienced a decrease in surplus.

Having made some further calculations, there were potentially $41 million so returned in those eight companies, including the interest on the previously held surplus, which represented 54 percent of those dollars. This is a minor amount of money compared to some of the industry proposals considered in the last few weeks, such as prohibiting a 7.5-percent deduction on mutual company dividends. This would arbitrarily tax something like $478 million in the same year. That is the amount which may potentially be overtaxed, compared to the $41 million that would be potentially undertaxed, a portion of which is a return of original investment.

This area of surplus calculation and distribution is an area I have done research in since 1975. I wrote a doctoral dissertation in the field, and it is one area in which I can be particularly useful to the committee here today.

The remainder of my prepared testimony deals with, as Professor Belth commented, tax treatment on the policy owners themselves. Specifically one item which I think would improve the industry position and the revenue position of the Government, as well as agents' income and a few other things, might be to consider treating life insurance which is purchased for business purposes in a manner consistent with the way in which other business insurance is purchased, and I have some specific recommendations in my written testimony I would be glad to elaborate on if you so wish.

[The prepared statement follows:]

STATEMENT OF NORMA L. NIELSON, PH.D.

My name is Norma Nielson. I am an Assistant Professor at the University of Southern California's School of Business. I have a Ph.D. in insurance from the University of Pennsylvania and have been teaching in the area of insurance for six years. Further details of my qualifications to testify on the subject under consideration today may be found in the resume attached to my written testimony. These qualifications may be examined by the members of this Subcommittee when time is not so scarce.

My testimony here will fall into three categories. Moving from the broadest areas to those of greater detail, I will first address the Subcommittee's concerns about the role of U.S. tax policy in retaining the competitiveness among various types of financial institutions for the American savings dollar. The second section deals with the relative competitiveness within the life insurance industry and the proper tax policies to encourage continued competitiveness. The third and final section deals with the tax treatment of the life insurance product to the policyowner, particularly the business policyowner.

COMPETITIVENESS AMONG FINANCIAL INSTITUTIONS

The tax treatment of life insurers should allow them to compete for investment and savings dollars on equal terms with other financial intermediaries. No one type of financial institution should have a comparative advantage or disadvantage as a result of artificial circumstances imposed by the tax law.

This question of the relative competitiveness of various financial institutions is a very serious one. I am convinced that the current tax structure places life insurers at a competitive disadvantage. In a report prepared recently by the Joint Committee on Taxation, it was reported that commercial banks in the U.S. enjoy an effective federal income tax rate of 2.3 percent. An insurer competing with this average top-20 commercial bank would, in the state of California, pay a 2.35 percent premium tax to the state before it even became concerned with Federal Income Tax. In order to provide any degree of equity, a minimum requirement is that federal tax laws allow a full tax deduction for premium taxes paid to the state in which insurance business occurs. This special tax on insurer's gross income often exceeds the average Federal Income Tax paid by its competitors and must be paid even by insurers suffering operating losses. The tax deductibility of gross premium taxes is needed even if some sort of multi-phase system is retained. Currently some insurers are taxed on the basis of their phase I taxable investment income (even if they suffered a net loss) with no Federal Income Tax deduction for state premium taxes paid.

This unequal tax treatment at other levels of government must be fully recognized if Federal tax policy is to move toward its goal of placing the different types of financial entities on totally equal footing for Federal Income Tax purposes.

COMPETITIVENESS WITHIN THE LIFE INSURANCE INDUSTRY

Reasons given for basing the taxable income of life insurance companies on anything other than total gain from operations can no longer be justified. The only requirement for this to be a "fair" treatment is that adequate recognition be given the needs for reserves against future losses.

Reserves

Life insurance reserves are calculated according to various formulae ranging from the full net level premium reserve to the full preliminary term reserve. Most companies use a modification of the full preliminary term reserve which is called the Commissioners Reserve Valuation Method (CRVM). It is exactly the full preliminary term reserve except in a few cases where the state insurance regulators have determined that it is overly liberal in freeing funds from reserves. These exceptions are policies with high premiums and a short period of time over which premium payments are paid.

With the state of modern technology, little need exists to maintain inaccurate approximations such as the Life Insurance Company Tax Act of 1959 provision for revaluaton of preliminary term reserves. I would recommend abolition of this approximation on new business and permanent extension of the provision to change to an exact method of valuation without permission of the IRS. For those companies electing to continue the approximation, the $19 adjustment amount should be decreased annually. I would estimate that a $2 per year decrease will eliminate the attractiveness of the approximation method within a few years while allowing companies who have relied upon the letter of the tax law in their product design to develop new product lines.

I would favor requiring the election of actual or approximate reserves to apply to a company's (or controlled group of companies') entire book of life insurance policies. Selection on the basis of individual lines of business should be avoided. A firm which has the technological capability to re-compute exact reserves on one line of business which previously used the approximation method has the capability to do so across its entire book of business.

Full deduction from gain from operations should be allowed for the establishment of reserves against future losses. Using the proposed CRVM method of valuing reserves would mean that the amount required to increase the CRVM reserve to its appropriate level at the end of a taxable year would be a deductible expense. The transition to the CRVM exact calculation is critical. The first year deduction should be the end-of-year CRVM minus the beginning-of-year CRVM values. The remainder of the amount, if any, of the excess of the beginning-of-year CRVM and the comparable amount using the approximation method must be given some special consideration. I would recommend treating this amount for both stock and mutual companies in the manner described below for the so-called Phase III "overhang".

In addition, I would allow firms to set aside an account which I will call "Reserve for Risk Bearing" in this testimony. This would be an assigned surplus account. It would allow the insurer to set up a specific contingency reserve to cover its estimated potential risk in various lines of business. This reserve would be relatively larger in nonparticipating life insurance than in participating life insurance. I would allow an insurer a deduction for increases to this reserve which are deemed to be "reasonable". (Presumably, the IRS will have to develop guidelines as to what is a reasonable contingency reserve.)

Such a recognition of the relative risk-bearing roles of different types of insurers would eliminate the need of an automatic special deduction to nonparticipating life insurance and group accident and health insurance while allowing deduction for reasonable provision in these lines. I would expect the need for contributions to this special contingency reserve to be limited to those lines of business, such as life insurance, where the basis for reserve calculation is specified in state laws. Lines such as group accident and health insurance have no restriction as to the method of calculation of reserves. Needed contingency provisions can be made in the normal reserving process; no special deduction is indicated. Previous law allowed further automatic deductions even for an insurer moving its business from more risky lines to less risky ones.

SPECIAL TRANSITION PROBLEMS

This transition tax treatment is the most important one which the Congress must decide. The tax deferral allowed life insurers in the past, as well as the untaxed amount released by a change in the reserve computation methods for tax purposes, cannot be added to taxable income in one fell swoop. This would create great disruption and hardship to some segments of the industry. On the other hand, complete forgiveness would create a windfall which cannot justified in light of current budget problems. These untaxed amounts, though they have not always been accounted for as deferral accounts, have been just that. I would recommend that these amounts be carried forward in a manner similar to the Phase III tax requirements under current law. These deferral amounts should be used to reduce future operating losses which would otherwise be available to carry back and forward. Under no circumstances should the insurance companies be allowed to receive a refund on tax paid in previous years when those years produced additional income which has not yet been taxed.

DIVIDENDS

Traditional life insurance contacts may be one of two varieties: participating or nonparticipating, i.e., one in which dividends will play a major role in determining the ultimate cost or one which has a guaranteed cost/guaranteed benefit structure. Historically these contracts have been issued by mutual and stock companies respectively.

Full deduction for dividends to policyholders should be allowed for all types of insurance. These represent a return of an overcharge in the original premium. As this original premium was not (in most cases) a tax-deductible item, no tax should be imposed on the rebate given on that amount.

The main area of concern centering around the question of dividend deductibility is the return on equity included in this payment by mutual insurers. Legally, the policyowners in a mutual company are the owners of the company, so some theoretical basis does indeed exist for a portion of the dividend payment being considered a return on investment. However, in my opinion, it is not a matter of practical concern.

I examined balance sheets of 1661 life and health insurers for the year ending December 31, 1980. My premise for this cursory examination was that a firm which paid a dividend and experienced a decrease in surplus would, in a mutual company, be paying out amounts which are either a return of investment and/or a return on investment. Of these 1661 companies, 1258 showed an increase in the capital and surplus account. Or, in the language of other corporations, 1258 increased their retained earnings. Of the 403 firms showing a decrease in surplus, 379 were stock companies (and incidentally 167 where wholly-owned subsidiaries of another firm and probably are not being taxed on an unconsolidated basis).

That leaves 24 non-stock firms to consider. Nine of these showed neither an increase nor decrease in surplus; in most cases the company gains were used to strengthen reserves. Only 15 non-stock firms showed decreases in surplus. Three of these paid no dividends and to others which did not disclose any dividend are presumed not to have paid any. A scant eight firms out of 1658 examined showed a decrease in surplus and paid a dividend which could indicate a return of capital or a return on equity. (The two remaining firms were fraternal societies not subject to the normal tax structure of a life insurer.)

Looking at these eight companies more closely (and assuming arbitrarily that half of the payout from surplus was a return on investment), I discovered a potential $20.9 million equity distribution which would have remained untaxed with a 100 percent dividend deductibility rule. On the other hand, if 7½ percent of mutual dividends were arbitrarily prohibited a deduction as one compromise industry proposal suggested, $478 million of non-equity distribution could potentially be overtaxed. The potential for error in the direction of overtaxation is nearly 23 times the potential for erring in the direction of undertaxation. My conclusion, therefore, is that the equity distributions occurring in the dividend payouts of mutual consideration in taxation. Indeed, longstanding theory calls for each policy in a mutual company to make a permanent contribution to surplus. This finances the acquisition of a new policy just as previous policyholders financed the early years of one's own policy. This theory indicates that a typical policyowner not only loses return on his or her investment, but also a portion of the actual investment.

The other side of this question is the concern of stock companies that mutuals would, as a result of the full deductibility of dividends, be able to "manage" their tax liability more effectively than would stock insurers. If Congress determines this to be a serious problem, I would recommend limiting deductibility in the form of a minimum tax. For example, 90 percent of gain from operations could be specified as the limit on dividend deductibility. A limitation of this type effectively creates an alternative minimum tax on 10 percent of a company's gain from operations before dividends. Almost any change would represent an improvement over the current system; a limitation of some arbitrary dollar amount is the least equitable of any I can imagine.

Finally, let me state that I am strongly opposed to introduction of the principle of unbundling to contracts of life insurance. This "new approach" disregards the degree of savings inherent in a particular contract. The vast majority of traditional "garden variety" life insurance contracts still pay the modest (3 to 4 percent) rate of interest on which life insurance tax law is based. As all publications of this Subcommittee have indicated, however, there are new varieties of contracts on the market which have index-linked or other market rates of interest inherent in the contract and the corresponding reserve computation. What is needed is a crystal clear definition of dividend and, as a last resort, a tax may have to be imposed on the excess interest portion of that dividend which the policyowner receives in cash or a cash equivalent. If this type of proposal comes under consideration, I would find an exclusion of $500 per person of dividends to be an attractive way of reducing the penalty on "garden variety" life insurance purchased by individuals to provide family protection. In any event, no tax should be charged to the extent the policyowner leaves the dividend with the insurance company and uses it to purchase additional insurance under the provisions of his or her policy.

While the whole idea of taxing dividends is distasteful to almost all segments of the insurance industry, I feel it is an approach to be preferred over any sort of proxy tax. A proxy tax is hidden from the consumer and does little but reduce the competitive appearance of a life insurance product when its investment features are being compared with investment alternatives available from other sources. If more tax revenues are needed from this industry than can be raised under the other proposals, no tax law changes should be implemented which raise these dollars in a way which will impair the competitive position of the industry in the eyes of the consumer.

EQUIVALENT TREATMENT OF LIFE INSURANCE PRODUCTS UNDER TAX LAW

I have two broad suggestions for improving the equity of the tax treatment of the life insurance product, as opposed to the life insurance company. While these suggestions do not respond directly to the queries posed in the Subcommittees published Framework for Discussion, it is important that these issues be considered while all the pertinent related issues are clearly in mind.

My first suggestion is a simple one. I would recommend expanding the $50,000 exclusion on employer-provided group term life insurance through an indexing provision. A change scheduled to go into effect along with the rest of the tax indexing proposals in 1985 would be extremely consistent.

A more important and far-reaching change in the tax treatment of the life insurance product should occur in cases where the insurance protection is purchased for business purposes. I would recommend amending IRC Section 162(a) to tax business life insurance like all other business insurance. Specifically, I would allow a deduction for premiums paid as ordinary and necessary business expenses. It would then be necessary and appropriate to tax the proceeds, but this would have to be done in a special manner as I have described below.

Business life insurance is usually designed to meet one of two business needs (1) key employee insurance to provide funds for firm continuation if a key employee dies, and (2) Funding for a buy-sell agreement to transfer the ownership of the firm following the death of a principal. I would recommend establishing a procedure for taxing the proceeds of the life insurance policy in case (1) with an exception allowed for case (2). Congress must recognize that the key employee life insurance a firm purchases is designed to replace future income to the firm for a period of years after an employee's death. I would recommend taxing the proceeds of a policy used for key employees under a ten-year averaging method with as few differences as possible from the ten-year averaging already in force. Ten years is slightly longer than the typical key employee insurance plan is designed to replace; tax law could compensate for this by eliminating the provisions for a minimum distribution allowance for this application for ten-year averaging. Further directions would be required to instruct taxpayers taxed under a corporate or other non-individual tax rate table.

As general policy I would recommend that this tax on key employee life insurance proceeds be imposed UNLESS the proceeds are used to purchase ownership interest in the business from the deceased's estate within nine months of the date of death. This exception is necessary to prevent the proceeds from being taxed in the business and immediately re-taxed in the deceased's estate. The value of the ownership interests of the remaining owners has increased and will be taxed under the applicable capital gains law when they sell that interest. The nine month period was chosen to correspond with the filing period for the Federal Estate Tax return of the deceased.

Consistent tax treatment would tax the full cash value on surrender of a policy purchased for business purposes. No tax should be incurred if a policy is exchanged for one of another type or to cover a new insured under the provisions of the original contract. Again, however, an exception should be made if the funds are used to purchase the shares of the business from a disabled or retiring partner under the terms of a buy-sell agreement dated prior to the onset of the disability. The disabled person receiving the funds under such an agreement will be responsible for taxes on the appropriate basis. No penalty tax should be imposed if, for business reasons, the funds must flow through the accounts of the firm before they can accomplish their intended purpose.

In the scenario I have described dividends on business life insurance would be taxable in the same way they are taxed for health insurance, i.e., a dividend or retrospective rating credit reduces the deduction for similar coverage in the year the dividend is received. I would recommend the same treatment for business life insurance unless the dividends are used to purchase additional insurance under one of the dividend options provided by the policy. In such a case, no income is received; the additional insurance is purchased as an automatic protection against the growing value of the business and/or inflation. Another way of achieving this result would be to tax the dividends but allow an offesetting deduction for the additional insurance provided by the dividend option.

Of course, transitional rules will be needed for a change of this magnitude. I would recommend that business life insurance owned before the effective date of this legislation have premiums tax deductible at the option of the premium payor. Any deduction of such premiums would constitute an irrevocable election that the taxpayer is agreeing to the new tax treatment of proceeds as well as premiums. I would require the policyowner electing the new treatment to establish a proportion at the time the proceeds are received equal to the total premiums previously taxed divided by the total premium paid. This ratio would be the proportion of proceeds subject to tax on the ten-year averaging basis. For example, a policy purchased in 1974 would have 9 years of premiums paid. If this policyowner paid and deducted the tenth year premium and, sometime during 1983, the insured died, a portion of the proceeds would be taxable. I would recommend that the policyowner be required to pay 10% of the tax that would result from the entire proceeds being taxed under the new ten-year averaging. Some sort of provision to elect ordinary income treatment would be desirable for situations where the total percentage, dollar amount, or remainder after the purchase of company ownership interest is extremely small.

These changes, if enacted, will disrupt tax predictability to some degree. The Federal budget will experience a temporary dip while these funds flow through the system but should improve substantially in the long run as the increased amounts of coverage become subject to taxation. the short-run drops will be substantially offset by the increased tax paid by the insurance companies and the insurance agents.

CONCLUSION

The taxation of life insurers is badly in need of an overhaul. These tax laws have become outmoded not only as a result of inflation and higher interest rates, but also as a result of the increasing sophistication of technology and of the average consumer of financial services. In these few pages I have presented several ways in which the obsolete provisions of the Life Insurance Company Tax Act of 1959 can be brought into the 1980's. These changes have sought to improve and maintain the equity of the tax treatment among various segment financial services, within the life insurance industry, and of the life insurance product.

It has been my honor to speak before you today. I truly hope my ideas have brought the members of this Subcommittee some additional insight into this complex issue.

SUPPLEMENTAL STATEMENT OF NORMA L. NIELSON, PH.D., MAY 31, 1983

I would like to accept Chairman Stark's invitation to provide further input to the Subcommittee on Select Revenue Measures regarding the equity interest in mutual company dividends. I feel these comments will be valuable because of the Subcommittee's expressed interest and the corresponding "center-stage" position this issue occupied in the May 10–11 hearings.

The primary purpose this supplemental statement is to expand upon the approximation I provided the Subcommittee for estimating equity distributions in a mutual life insurance company. My approximation was based on the theory that surplus in a given year is equal to the surplus from the previous year plus interest plus the gain from operations (GFO) net of dividend payouts. In equation form this relationship can be expressed as:

$\text{Surplus}_{t} = \text{Surplus}_{t-1} (1 + 1) + (\text{GFO})\text{—Dividends})$

Using this relationship aggregate annual dividends can be expressed as:

$\text{Dividends} + \text{GFO} = i \bullet \text{Surplus}_{t-1} + (\text{Decrease is Surplus}_{t})$

The premise of my earlier testimony is that this expression of dividends can be divided to reflect the policyholder/stockholder interests in the mutual company. The portion of the dividend which arises in GFO is properly attributed to the policyholder interests; its redistribution to policyholders serves to reduce the premium on the coverage as nearly as possible to the actual cost. The remainder of the dividend arises from the company's values as a "going concern," i.e., its previous accumulations of surplus. I interpreted this as the owner's equity portion of the dividend in my May 10 testimony. This value is comprised of two parts: interest on previously held surplus plus (minus) any decreases (increases) in surplus.

The amount so determined may represent either a return OF investment or a return ON investment. This derivation does not permit a breakdown into these smaller components.

The value I have derived here for owner's equity is accurate under either a cash or accrual accounting system. It is not so workable under life insurance statutory accounting which combines elements of both cash and accrual accounting. Life insurer gain from operations is essentially an accrual account. But, Federal Income Tax policy generally requires some items to be accounted for on a cash basis. These inconsistencies can have dramatic influences on statutory surplus and impair the direct applicability of the approximation I have provided here. For example, unrealized capital gains or losses cause much larger vacillations in the surplus account than would be appropriate for determining the equity payouts portion of a mutual company's dividend. Also, this theory considers only annual policy dividends; terminal dividends were excluded to keep the results relatively simple to comprehend and to compute.

To summarize, the approximation I have provided and supported here is a sound method. Care should be exercised when implementing this method with the amalgam of accounting systems which characterizes the life insurance industry. That is perhaps the greatest task facing the Subcommittee. I would be honored to provide further assistance in this or any other issuances before you in the coming months.

Thank you again for the opportunity to present my views.

Chairman **Stark**. Thank you, Ms. Nielson. We will get a chance to elaborate a little more in the question part of the program.

Mr. Aaron, would you like to proceed with your testimony?

STATEMENT OF HENRY J. AARON, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. **Aaron**. Thank you very much.

My name is Henry Aaron. I am a Senior Fellow at The Brookings Institution and the author of a recently published pamphlet on the peculiar problem of taxing life insurance companies, copies of which are in the hands of the staff and some of the ideas in which undergirded a fair amount of Secretary Chapoton's testimony.

Life insurance company income falls into three categories: investment income from policyholder reserves, investment income from company surplus, and underwriting gains.

The fundamental problem of taxing life insurance companies derives from the inconsistent treatment of savings in different forms under the income tax, which has a direct bearing on the manner in which the investment income on policyholder reserves should be taxed. Most people carry out most of their saving in tax exempt forms, through IRA's, Keogh's, qualified pension plans, owner-occupied housing, and social security.

Only a very small fraction of the population saves any significant amount through currently taxable forms. But there is a substantial amount of assets in such forms, concentrated in the hands of a relatively small number of taxpayers.

The question that needs to be resolved in deciding how to tax life insurance companies is, as many have observed, how to establish a level playing field. This question is of particular importance for the customer. Will the customer be able to invest in savings-type life insurance, on the same terms on which he or she is able to invest in IRA's, Keoghs, and the other tax-exempt forms which are the dominant instruments for saving by individuals? Or will individuals be taxed in currently taxable form, as is done with stocks, bonds, and other assets held privately?

Unless we wish to place a particular asset, savings-type life insurance, at a serious disadvantage in comparison with the predominant savings vehicles available to individuals, the appropriate manner of taxing life insurance companies is to provide an exemption currently for the investment income earned by life insurance companies on policyholder reserves.

That leaves the remainder of company income, investment income on company surplus and investment and underwriting gains. The taxation of those two elements of company income should be taxed, as Secretary Chapoton suggests, like other ordinary corporation income.

This principle can be applied relatively straightforwardly with respect to stock companies that sell only nonparticipating insurance. Serious problems arise with respect to the treatment of mutual companies, however, because of the very items that Secretary Chapoton stressed: the difficulty of sorting out the two elements of the policyholder dividends which mutual stock company investors, insurance holders, receive.

I know of no precise way by which to make the computation which Secretary Chapoton suggested is necessary. But I would suggest for serious consideration an imputation method: after allowing mutual insurance companies to deduct all policyholder dividends, to impute to them an equity return based on the company's surplus and on a fair market rate of return.

The exact calculation of that fair market rate of return I think is technically difficult. I have previously suggested that the basis should be the market rate of return on tax exempt securities adjusted upward to allow for the fact that in effect some of the earnings are retained by the corporation.

The final issue arises from the fact that the mix between stocks and mutuals creates some problems. It seems to me that a number of the provisions, many of which Secretary Chapoton listed in his testimony, such as the deduction for nonpar insurance or for accident and health, the special provisions relating to preliminary term reserves, have very little justification in terms of tax principles. They do not go to the fundamental issues that involve the relative tax treatment of savings in different forms.

Accordingly, I would suggest that one set an ultimate goal for the appropriate treatment of these deductions and special provisions, that they serve the purpose, to be blunt, of negotiating instruments in the course of putting together a tax bill that gradually moves toward fair and equitable treatment of stock and mutual companies.

[The prepared statement follows:]

STATEMENT OF HENRY J. AARON ON THE PECULIAR PROBLEM OF TAXING LIFE INSURANCE COMPANIES

In deciding how to tax life insurance companies one must resolve three fundamental issues and solve a host of derivative issues. The first and most important question is whether to tax life insurance according to the principles of comprehensive income taxation or of consumption taxation. The second question is whether mutual insurance companies should be taxed at all and, if so, what principle should underly that tax. The third question concerns what the relative tax burdens should be on stock and mutual companies to achieve a reasonable degree of "balance" between them. In addition to these three interrelated questions, which I have characterized as fundamental, there are many other important practical issues, some of which have major tax consequences. The resolution of these questions can help establish the desired balance between stocks and mutuals. My testimony is divided into three parts dealing respectively with each of the three fundamental questions. I shall assume throughout that we intend to retain both a broad-base tax on individuals and an income tax on corporations.

THE TAX NORM: INCOME FROM POLICY HOLDER SAVINGS

Life insurance provides a current service, protection against risk, and it is a savings vehicle. Accordingly insurance companies earn income from two distinct types of activities; as fiduciaries, they earn investment income for savers, and as purveyors of a service, the reduction of risk, they earn ordinary corporate profits and investment income on company surplus. The gist of my testimony is that these two types of income should be taxed differently.

The United States has an income tax on individuals and on corporations. However, many sources or uses of individual income are treated not according to the principles of "income" taxation, but as they would be under a broad-base personal consumption tax. The result of this eclectic—some would say confused and contradictory—system is that commodities or assets taxed one way may compete in the market with commodities or assets taxed another. The internal revenue code treats personal saving differently depending on the form in which it is carried out. Saving through qualified pension plans, IRAs Keogh plans, and owner-occupied housing are fully sheltered from current tax, as is income earned on those assets. Saving in most other forms and income earned on such savings are fully and currently taxed, except to the extent that income is mismeasured, for example because of excessive or insufficient deductions for depreciation.

The fundamental question is whether life insurance is to be treated like tax sheltered saving, fully taxable saving, or somewhere in between. Because virtually all of the assets of most people are held in forms that are tax sheltered, a decision to tax investment income on policyholder reserves would place life insurance at a great disadvantage in competing for savings of most current or potential customers. Unless we wish to use the tax system to put life insurance companies at a serious disadvantages in competing for savings, investment income of life insurance companies should be treated like pensions, IRAs, and Keogh plans.

That goal can be achieved in either of two ways. If premiums are paid from income that has already been taxed at the personal level, no further tax should be imposed on investment income at either the company or the personal level, and no tax should be imposed on recipients of the proceeds. If premiums are paid from income that has not been taxed at the personal level, no tax should be imposed on investment, but the proceeds should be taxed in full at the individual level. IRAs, Keogh plans, and qualified pension plans follow the second approach. Because most savings-type life insurance is bought by individuals who pay for it with after-tax income, the first approach is indicated.

The only modification to this principle that is in order applies to policies that entail very large cash values relative to the value of insurance, such as some universal life insurance policies. While the exemption from current tax is necessary to permit insurance companies to compete with other fiduciaries for current saving, the unlimited availability of such an exemption would permit wealthy individuals to avoid all tax on capital income by moving their assets under a tent like universal life insurance. To prevent such an undesirable consequence, it would be necessary to limit the exemption of investment income on policyholder assets from current income to policies that had no more than stipulated maximum ratios of cash value to insurance value.

A corollary of this argument is that the Menge formula should be repealed. The Menge adjustment does not correspond to actual contractual arrangements. Companies should be taxed on income not actually allocated to policyholders in their capacity as savers.

A case can be made for taxing investment income on savings-type life insurance only if the entire tax system is reformed so that the principle competitors with life insurance are taxed in a similar way or if we wish to use the tax system to discourage the sale of savings-type life insurance.

MUTUALS AND STOCKS

None of the preceding discussion goes to the treatment of underwriting gains or investment income on company surplus. As long as we retain a corporation income tax, these sources of income should be taxed in the same way as business income of other corporations.

To say that the presence in the insurance industry of both stock and mutual companies complicates matters is to speak with comic understatement. The already formidable task of trying to figure out how to tax companies dispensing a product as complex as life insurance is vastly compounded by the fact that the ownership interest in mutual companies is diffused and legally cloudy. The principle enunciated in the previous section—that investment income of insurance companies on funds held for policyholders should be exempt from corporation tax—still leaves unanswered the question of how remaining income should be taxed.

In some industries, the position is adopted that mutuals should be exempt from all tax, while profit making companies are taxed. I believed that such an approach is bad tax policy in general; but whether or not one accepts that view, the practical fact is that no other industry is so evenly balanced between mutual and stock companies. Balance is some dimension between taxes imposed on stock and mutual companies has been a major objective for decades.

To achieve such balance does not necessarily imply that the ratio of taxes paid to assets or to premium income or to investment income should be the same for mutual as for stock companies. Rather taxable income should be defined the same way for both mutual and stock companies. I use stock companies as the point of reference because the ownership interest is more clearly defined than for mutual companies. For the time, I shall also assume what I know to be false, that mutual companies sell only participating insurance and that stock companies sell only nonparticipating insurance. Under the corporation income tax, the objective is to tax profits that accrue to the owners. For stock companies, the owners are the shareholders. In a stock company assets are held either for policyholders or for the company. If income on policyholder reserves is untaxed at the company level, the company tax base should be defined as underwriting gains plus investment income on company reserves.

To achieve parity between stocks and mutuals, the same principle should be applied to mutuals. The problem is how to distinguish the portion of company income that is a return to policyholders *as owners* from the portion that is a return to them *as policyholders*. The latter portion should not be taxed at the company level, according to the argument presented in the preceding section. The former portion should be taxed at the company level.

I know of no precise way by which to measure the "profits" earned by mutual insurance companies, because policyholder dividends jumble together price rebates and investment income on policyholder savings as well as what amounts to company dividends. As a practical expedient, I suggest that profits of mutual companies be imputed in an amount equal to the companies' accumulated surplus, multiplied by a moving average of the market rate of return on tax exempt securities. The rate on exempt, rather than taxable, securities is appropriate because policyholder dividends are exempt from individual income tax. This procedure should be applied by allowing companies to deduct policyholder dividends in full and then requiring them to add back to taxable income an amount equal to the product of company surplus and a moving average of the rate of return on tax exempt securities.

It is worth noting, at this point, that some mutual firms are engaged in litigation that makes them averse even to the suggestion that policyholders are owners. To implement the proposal that I am making requires only the legislation of a particular formula and does not require any explicit mention in legislation of who owns mutual companies.

If this rule had been applied to mutual, but not to stock, companies in 1978 and 1979, it would have reduced the effective tax rate on mutual companies to approximately the level incurred by stock companies. In fact, there was a wide difference, more than 20 percent of properly defined taxable income. The widespread use and abuse of modified coinsurance in later years reduced this differential.

In principle, similar treatment should be accorded to participating insurance issued by stock companies. But the practical problems would be formidable and might be insuperable. For this reason, the direct exclusion from the tax base of a percentage of policyholder dividends, as is done under the stopgap provisions now in effect, might be necessary for stock companies.

BALANCE

It is common to compare the ratio of assets, premium income, or insurance-in-force of stock insurance companies to those of mutual companies to judge whether the relative tax burden of stock and mutual companies is fair. Such comparisons are meaningless and should not form the basis of allocating tax shares over the long run. The corporation income tax is a tax on profits, not on assets, a fraction of income, or sales. Insurance companies earn net income in part for policyholders, in part for owners. If one is going to treat insurance companies consistently with other corporations in the long run, total income should be measured, the proportion allocated to shareholders as savers should be exempt from company taxation, and the remainder should be taxed to the company.

The result of ruthless application of these principles, however, may in the short run redistribute tax burdens between stock and mutual companies. The result could easily be serious disturbance to the insurance industry.

Traditionally, several provisions affecting the taxation of life insurance companies have been justified, in part, as methods of achieving balance. It would be politically and economically naive to suppose that an abrupt reorientation of tax burdens would be desirable. For that reason, it may be necessary to retain certain provisions that have little apparent rationale. One example is the special deduction for nonpar insurance. If there are special risks in nonpar insurance, good economics suggest that they should be handled by reinsurance or that they should be reflected in price. A second example is the provision that permits companies to expense selling costs of insurance and to increase reserves at the same time. Neither of these rules makes much sense, but flexibility regarding them will make it possible to achieve the kind of balance that most representatives of the insurance industry regard as indispensible and that members of Congress are likely to find appealing.

Chairman STARK. Thank you very much, Mr. Aaron.

The portion of the premium in a mutual company that could be called paid-in capital has been taken into income by the policyholder or run through the Tax Code system. How do you rebut that?

Mr. AARON. Let me see if I am clear on the question. Premiums are typically paid for savings-type insurance out of after-tax income, which has already been taxed.

Chairman STARK. Correct.

Mr. AARON. The issue is, should that again be taxed, because it is in effect profit to the company.

Chairman STARK. Yes.

Mr. AARON. And is added to company reserves.

Chairman STARK. If you are trying to attribute a stock equity ownership interest to a mutual, much of their capital comes in that form rather than after-tax buildup of shareholders' reserves, as would build up in a stock company.

Mr. AARON. If I understand your question correctly, I think the answer to that is that we at present have a two-tier tax system, in which we separately tax individual and corporate income. If individual income is used to buy products of any sort and the seller of the product earns a profit, we separately tax that income.

The reserves in effect constitute the base of the company's operation, on which the owner implicitly earns a rate of return.

Chairman **Stark**. Ms. Nielson, you and Professor Belth both have introduced a couple of new concepts on the deductibility of business life insurance. You mentioned in your testimony a couple of reasons for that. I guess I could see a necessary business purpose in certain key person life insurance where one could establish that the unique services of an individual could cause an economic hardship on the enterprise.

It is a little more difficult for me to think of partnership buyouts and that sort of thing as a business purpose. It seems to me that that more logically falls in the estate tax bucket, if you will, and we have already provided long-term buyout provision and a whole host of accommodations for that problem. I do not see that as logically the same thing as insuring against product liability or insuring against your factory or store burning down.

Would you agree that you need as narrow a definition as I am suggesting for the logic to apply that it ought to be a deductible business expense?

Ms. **Nielson**. I think it is a very, very fine line, particularly in a small, closely held firm with two or three or even one owner: Is that owner being insured as the key manager-operator or is that owner being insured so that the business can continue at his death?

The mechanism for that——

Chairman **Stark**. I think you get very close, then, to taking the unique person who provides a key service. In the entertainment industry, for instance, you buy life insurance to replace lost income due of the loss of an opera tenor or a ballerina, when in fact that life value is very difficult to measure. And I doubt if there is a reasonable and necessary business expense. There may be a socially desirable benefit to surviving spouse and dependents, but——

Ms. **Nielson**. Many times the function the life insurance serves is to allow the business to continue, period.

Chairman **Stark**. But where the business is an individual, it seems to me that destiny has arranged for that not to happen. So you either have to have an enterprise in which the people who operate it are replaceable or, if it is so unique, as in a small business, you lose the business purpose.

Ms. **Nielson**. I would disagree. There are many cases with two to three key people, which are more than the one-person operation you are referring to and less than the General Motors, which insures its chairman of the board.

Chairman **Stark**. And you think you could find an empirical way to determine the loss or potential loss to the enterprise for the untimely death of one of those people?

Ms. **Nielson**. I have done some theoretical work in that area, but it remains just that, highly theoretical. The insurance companies have instead some rules of thumb that they use for selling the key employee life insurance.

Chairman **Stark**. I am sure of that, but I am not sure that that relates to the discussion that you and I are having.

Professor Belth, your unique contribution to this is the idea, which I might add the Chair shares, that the average American is woefully underinsured. I guess I base that on the money value of man sort of concept, that the purpose of insuring a life is largely to replace potential lost income. And to the extent that you are replacing that income for the surviving dependents, it may be changed some from the early days of Huebner's because of the dual earning role of many partnerships.

But aside from that, I do agree with your idea of some particular tax deduction to reach a goal, to reach a goal of protection. Would your suggestion be reasonably limited in a manner such as to not purchase any more pure protection than would provide the replacement of income as could be reasonably projected due to the loss of the person you are insuring, with some kind of a cap so as to not tilt toward extremely high income individuals?

Mr. BELTH. Well, Mr. Chairman, that is a possibility. When I referred to a possible ceiling, I was referring to something somewhat simpler than that, possibly a dollar per year type of ceiling.

Chairman STARK. This is a question for the entire panel. I am sure that you heard Treasury's view that some portion of the capital provided to a mutual company by its policyholders generates earnings, which should be treated when they are returned to the policyholders not as a reduction of premium but in much the same manner as a dividend to a stockholder.

From your various surveys, do you feel that imputing those earnings is correct as a policy matter, and do you have any suggestions to the committee as to a manner in which one might arrive at determining that amount? Mr. Aaron, we will let you lead off.

Mr. AARON. Well, first of all, I think Secretary Chapoton's suggestion with respect to policyholder loans is an attractive one.

Chairman STARK. Policyholder loans or policyholder dividends?

Mr. AARON. Loans.

With respect to policyholder dividends, that issue should be resolved in the broad context of how we want to treat different forms of savings. If one taxes investment income on policyholder reserves at the company level, or if you do the same thing at the individual level, provided that the insurance is purchased out of after-tax income, that is going to be putting that form of insurance at a distinct disadvantage relative to the other forms of savings.

With respect to the profits that would be imputed to mutual companies and the profits actually earned on participating insurance of stock companies that are paid out to policyholders, it seems to me that there there is a stronger case for taxation at the individual level, to put such income on a par with income from dividends or bonds.

And may I add one more point. It seems to me that a major issue involves the fact that we do have this bifurcated treatment of savings. Very large holders of wealth, except to the extent that we mismeasure income because of provisions of the Internal Revenue Code, hold most of their assets in taxable form. They may take advantage, to the extent that they have good tax planners, of special tax shelters, but we do not have an explicit exclusion of asset income, as we do for the predominant savings forms for middle and lower income people.

I think there is a serious problem, to which Secretary Chapoton referred, of preventing holders of large amounts of wealth from moving assets wholesale into tax-sheltered insurance, and that some kind of definition of insurance along the lines that he suggested or perhaps more strict——

Chairman **Stark**. If I could interject here. I have used the illustration, and the Secretary touched on it, that if you took a large manager and seller of mutual funds, for example, it does not take much of a stretch of present law for that mutual fund manager to merely have available to the stockholders in the mutual fund a very minimal cost term insurance, package it in a simple contract, and suddenly all of the buildup in the mutual fund becomes tax-free.

Now, that is getting pretty extreme, but I think that is the kind of procedure that the Secretary was referring to and I gather what you are now referring to.

Mr. **Aaron**. Yes. I would also suggest that any investment income earned in the policyholder's name be subject to a variety of restrictions on early withdrawal, as we do with IRA's and Keogh's. There is a penalty tax if those funds are withdrawn before age 59½. Something that would keep the playing field level it seems to me would be in order as a reasonable quid pro quo for the exemption of the policyholders' investment income from current taxation.

Chairman **Stark**. Professor Nielson, do you want to suggest how we can level that playing field between mutual and stock companies and solve all the problems for us right now?

Ms. **Nielson**. I can give you the approximation that I used to estimate the portion of dividends that would be a return of or on equity. Again, some of it could be a return of previously paid-in capital. If you just take the company's portfolio interest rate times the previous year's surplus and add any decrease in surplus during the year, or alternatively, subtract any increase and express that as a percentage of dividends. The vast majority of the companies, you may be surprised, would have a negative return using that approximation.

In theory, the policyholders in a mutual company do make a permanent contribution to surplus by participating in the company. They may well expect a negative return on their investment.

Chairman **Stark**. Professor Belth?

Mr. **Belth**. Mr. Chairman, my only comment on this point is that I believe it would be possible and possibly even practical to examine not so much the individual components of the structure of a life insurance policy, but the total structure of the policy and arrive at what might be referred to as the death protection component and what might be regarded as the savings component, and handle those in whatever way would be considered appropriate for tax policy, given certain social objectives of tax policy.

I think that to look at dividends alone, without considering the other elements of the policy structure, would not be the appropriate procedure.

Chairman **Stark**. Thank you all very much.

Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman.

I want to thank the panel.

Mr. Belth, you indicated that in developing a system of life insurance taxation, perhaps a greater emphasis be put on selling death protection. Isn't death protection, instead of investment the main reason for buying life insurance?

Mr. **Belth**. Congressman Duncan, I believe that the primary motivation may generally be death protection. But I feel that the bulk of the premium dollars flowing into the life insurance companies are not providing death protection. The bulk of the dollars are over on what I call the financial intermediation function of the life insurance companies.

Mr. **Duncan**. Well, are there not other inducements now? When you turn on the television, some insurance company is selling death protection, not investment protection. There seems to have been a big increase in that in the last year or so.

Ms. Nielson, you are kind of smiling. Would you care to comment?

Ms. **Nielson**. I was thinking that may have been for the benefit of groups like this.

Mr. **Duncan**. Mr. Aaron, would you care to comment?

Mr. **Aaron**. My only comment, it seems to me that the function of death protection is adequately encouraged by the very favorable treatment accorded term life insurance purchased by employers, which is undertaxed under any taxing norm. It is an element of income, it is an element of consumption, but it is not taxed at all to anybody.

I think that there is a case for reexamining the dollar limit on that exclusion, but I would hesitate to urge that unless one took a much broader look at the treatment of fringe benefits of all kinds, an area that needs a close look, to say the least.

The administration has made a salutary proposal with respect to health insurance, although I gather it is not the most popular thing to come down the street lately.

Mr. **Duncan**. Thank you very much.

And thank you, Mr. Chairman.

Chairman **Stark**. You certainly hit on some interesting ideas. I think we will put off fringe benefits until we solve the easy ones first.

Mr. Flippo.

Mr. **Flippo**. Thank you.

Professor Belth, in your opinion what would be the impact of a change in the tax laws along the lines suggested in your statement on capital formation in the United States?

Mr. **Belth**. Congressman Flippo, that is a very difficult thing to forecast. It is possible that the type of shift in policy that I was alluding to in my statement might cause life insurance companies to put somewhat greater emphasis on the sale of death protection and somewhat less emphasis on their financial intermediation function, and this might cause some modification in the way in which the total capital formation in the country is carried out.

But I simply cannot predict what kind of effect that would have on the total, or even the way in which the total would be distributed among the various financial intermediation industries.

Mr. **Flippo**. Is it reasonable to conclude from your remarks that you feel that the insurance industry does not do a good job in encouraging savings, or—I really think that in your concluding remarks you state a belief that Federal tax policy has consistently favored the savings function in life insurance, and I believe you are suggesting that we alter this approach.

Mr. **Belth**. Yes.

Mr. **Flippo**. I am wondering if your remarks are based on some assumption that perhaps the insurance industry has not done a good job in encouraging savings, or is it simply that you feel that it distorts the basic objective of life insurance?

Mr. **Belth**. No, I am not intending to suggest that the life insurance industry has done an excellent, good, fair or poor job of encouraging savings. My sole purpose in making remarks is that I believe that the tilt, if I could use that word, in tax policy has favored the financial intermediation function of life insurance companies, and I am merely suggesting that consideration should be given to an alteration in that policy to put greater encouragement on both companies to sell and consumers to buy death protection.

Mr. **Flippo**. I see, and that has been the basis for your feeling that most Americans are underinsured?

Mr. **Belth**. The feeling that most Americans are underinsured is the reason why I am suggesting consideration of an alteration in tax policy.

Mr. **Flippo**. Thank you.

Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I appreciated your statements. Professor Nielson, I agree with the notion that tax policy should not impact the insurance industry in a way that would make them noncompetitive with other financial industries.

You compared that with a study that showed that the banking industry in the country paid something around 2.7 percent in effective tax rate. That it seems to me is a problem that this committee will correct at some point in the coming months, and one should not peg the anticipated level of taxation for the insurance industry at an equivalent 2.7 percent that the banks are shown to be paying in the recent studies. My guess is we will be correcting that at some point in the future.

Ms. **Nielson**. That was not my intent.

Mr. **Dorgan**. I would like to ask you a question about the testimony earlier by the Assistant Secretary of Treasury. He talked about the limitation on the deduction of policyholder dividends, and he suggested that we use a "corporate profit" construction of trying to analyze the measure of nondeductibility of the dividends.

He didn't give us any specifics, but how do you feel about that general approach?

Ms. **Nielson**. Well, the approximation I gave the Chair just a moment ago is a simple version of that, and as I indicated, in most of the mutual companies it would result in a negative corporate profit being passed on to the imputed stockholders.

Chairman **Stark**. Would the gentleman yield?

Mr. **Dorgan**. I would be happy to yield.

Chairman **Stark**. You are taking, though, the company's stated surplus as your basis of calculation. If we recalculated the reserves as Secretary Chapoton suggested, those reserves might be unnecessarily high because they are set by State regulation, whose interest is financial security and not necessarily taxation.

But if that surplus were enriched by what some might consider the excess reserves set-aside, they might have a very substantial income, is that not correct?

Ms. NIELSON. That would probably be true in a few companies, but most of them are using the CRVM or other moderate methods, again relatively conservative assumptions. But there were new mortality tables published in December of last year by the Society of Actuaries and the companies will be using those as soon as they are approved by the various States.

They are not going to lock themselves into unreasonable assumptions and deficiency reserves to lower their Federal taxes.

Mr. DORGAN. Well, the specific impact of that is going to be of great interest to us. The suggestion by Mr. Chapoton of using a concept of corporate profit as a measure of the nondeductibility is something that we are going to want to look at in order to determine what the effect of it would be.

I would like to ask a more general question of all three of you if I might. One of the concerns of some of us has been that instruments have been offered by life insurance companies that are really investment instruments rather than insurance instruments, and that has led some people to believe that the buildup, nontaxed buildup in those instruments, ought to be taxed. This comes back to the suggestion Mr. Chapoton made about really defining what is a life insurance contract, and I think Mr. Aaron referred to that as well.

Do you share a concern that instruments are being offered that are basically investment instruments and we need to tighten that?

Mr. AARON. No; I do not think I do. We as a nation have been moving away from the principle that we should tax income on investments. We still have what is called an income tax, but most Americans live under a tax under which practically all savings is exempt from current tax.

If you invest a dollar in an IRA, a Keogh, a qualified pension plan, if you pile up capital gains in an owner-occupied home, if you accumulate social security benefits paid for by your employer, most of that until now and most of it still is tax-exempt.

At the time you receive income from these sources you typically must declare as income any accumulation above the payments that you personally have made out of already taxed income. Social security was even more favorably treated than that.

So for most people the idea that we should tax investment income currently is a dead letter, and the gist of my testimony was that I thought that on balance insurance with the savings component should be put on a par with those kinds of savings. I would add the proviso that you do not open a tax loophole through which the wealthy could drive all their assets.

Mr. DORGAN. I understand that concept and I share the need to provide incentives for investment savings. That, however, is always in conflict with the question of equity in a tax system, as you understand, because predominantly the persons who are receiving income from savings and income from—that is, so-called unearned income—are either having, experiencing a tax-free condition or a lower condition, and therefore that always conflicts and does damage to the question of fairness in a tax system.

So that is the kind of problem we are dealing with. I understand your comment, and I was trying to elicit from you whether you found that some insurance contracts have gone far afield of the normal insurance path and moved into the investment path.

Mr. AARON. Yes, I do. I think limits would need to be placed, and since I have described what I think would be a fairly generous treatment of the inside buildup, I think the limits on policies that should qualify should be very carefully drafted.

Mr. DORGAN. I have no further questions, Mr. Chairman.

Chairman STARK. OK.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I too would like to thank the panel. We on this subcommittee and full committee potentially at least have the power to shape the Tax Code for almost any type of insurance. If we were to evolve a method whereby the only product sold was straight term or products offering only a death benefit, would that create any changes in our society as we know it now? If we drew it very narrowly and made a conscious effort to eliminate any savings involved with the insurance industry, would that be beneficial or detrimental?

Ms. NIELSON. If I may speak, it would be extremely detrimental. If you were to eliminate, from Mr. Chapoton's example, a case where a 35-year-old, I think he was using a male, would pay $1400 per year for insurance protection, you would instead find, as the gentleman I met on the plane coming here yesterday, 67 years old, he would either have to pay $6500 for that coverage or not have it.

And while we are lauding the benefits of savings for old age, the vast majority of people have not done that and could not afford $6500 for a $100,000 policy.

Mr. SCHULZE. Any other thoughts?

Mr. AARON. My instinct on that is that people would be forced into packaging things in very complicated ways if they wanted to achieve the mix of savings and life insurance protection that they now can get in simpler forms.

I think it would have been possible for this hypothetical 35-year-old to take the extra money when he was younger, invest it, and accumulate income, which he could then use to pay the premium for himself when he was 65. But most people would not do that. I think there would be some loss from that move. I cannot see any real gain from it.

There would be serious disturbance in a major industry. There would be a serious need to reallocate the flow of capital among different financial intermediaries, and there would be this additional complexity that people would face because products that combine desirable attributes would not be available to them.

Mr. SCHULZE. I am getting the message that insurance companies sell policies on an individual basis, and we are such a diverse nation that they need a wide variety of instruments in order to satisfy those needs? Am I correctly paraphrasing?

Mr. AARON. I think that is right.

Ms. NIELSON. I would agree.

Mr. BELTH. Congressman Schulze, I would like to make a somewhat different comment on this point. If you attempted to eliminate life insurance companies from the financial intermediary function, aside from the possible consequences for capital formation, it might have the result of changing rather drastically the way in which life insurance is marketed.

We have not said too much today about this point. That is why I thought it might be appropriate to bring it up. When it comes to individual life insurance, most of the life insurance is sold through the efforts of agents, who persuade individuals to think about death and think about the financial consequences of death and then, even more significantly, try to persuade individuals to avoid procrastination about meeting their needs.

And it might be that something as revolutionary as an effort to eliminate altogether the savings function of life insurance might make it difficult to provide the kind of compensation that would be necessary to keep agents performing the functions that I just outlined.

Mr. SCHULZE. If we did that there would be no agents, you are right. I think they would probably be eliminated. It would all be sold by mail order.

Mr. BELTH. The point is, if we eliminated the agents I am convinced that the amount of life insurance sold would be extremely small.

Mr. SCHULZE. And that would be detrimental.

Do the customers dictate the type of policies that are drafted and produced by insurance companies or do our tax laws dictate those policies?

Ms. NIELSON. I would guess it is a little of both. Historically, things like the family income and family maintenance policy or face plus cash value policy developed because it was an easier concept to explain and understand to the consumer. In recent years, the tax policy has probably been slightly more influential.

Mr. AARON. I think the answer is that much of the innovation that has occurred in recent years has been motivated by the interaction of our tax treatment of interest income and the tax laws—that the diversification of products, universal life, the tax issues that have arisen with respect to policyholder dividends and their greater importance for mutual companies—because of change in the economic environment that interact with tax provisions.

Mr. SCHULZE. I presume this is not one of your concerns, but I also would guess that you are aware that our savings rate is either the lowest or one of the lowest among the industrialized nations of the world.

Mr. AARON. I am very concerned about that, and for that reason I urge you to deal promptly and effectively with the Government deficit, which dollar for dollar offsets that saving and takes it away from potential private investment.

Mr. SCHULZE. By cutting entitlements, did you say?

Mr. AARON. I said with the deficit.

Mr. SCHULZE. I agree and I think that that is something we have to do. We have historically had a bias against savings. It seems to me that those things which we can encourage through the Tax Code and perhaps even through the taxation of insurance to increase capital formation should be emphasized since they are beneficial to the society as a whole by providing capital and jobs.

Mr. AARON. I could not agree with you more, but I would urge you to focus on those aspects of the present tax law that permit people to accumulate assets in tax-exempt form without doing any net saving, by switching assets, by borrowing in order to finance buildup in tax-exempt assets. That would do more for increasing savings than offering additional forms of tax-exempt savings.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Mr. DORGAN. Would the gentleman yield?

Mr. SCHULZE. Certainly.

Mr. DORGAN. The answer you gave with respect to the Federal deficit, I happen to share your concern and your interest in that. Just within the last several days, the Secretary of the Treasury gave a different answer on the impact of the deficit. He seemed to suggest that the notion of crowding out was not a valid notion and that the effect of the deficit on interest rates was not an effect that anyone could trace.

How do you respond to that? I happen to agree with you, but that seems to be in disagreement with the statement of the Secretary of the Treasury.

Mr. AARON. I think it is a complicated question, and the answer is that for the next couple of years I would agree with the Secretary. It is important not to use fiscal instruments to damp down the economy during the early phases of recovery, and that means it is important not to have large tax increases or large expenditure reductions for fiscal reasons. You may want to do it for policy reasons. I am not addressing that.

But as we move ahead into 1986, 1987, 1988, we are looking at a situation where our net savings rate is about 8 percent and at Federal deficits that are going to be running 4 to 6 percent of GNP. That means one-half to three-quarters of our net private domestic savings is going to be eaten up by Federal deficits. So that is the focus that I was referring to earlier.

Mr. DORGAN. You are saying that the crowding out theory does have validity?

Mr. AARON. It is a matter of plain arithmetic. Either we make room for private investment by shrinking that deficit or by borrowing from abroad, or we reduce investment. The United States borrowing from the rest of the world to finance its growth is a rather grotesque image.

Mr. DORGAN. And if one counsels Congress not to use fiscal instruments to deal with the deficit and if Congress does not control monetary instruments, the Federal Reserve would have a very difficult time dealing with that. I certainly share your concern.

Chairman STARK. Mr. Jenkins?

Mr. JENKINS. Thank you, Mr. Chairman.

I want to thank the panel. I do intend to study your statements in detail. You have made some recommendations that are different from those in some of the other statements.

Dr. Nielson, let me ask you this. The study that you made indicated that most of the dividends paid out by insurance companies was a return of premium.

Ms. NIELSON. It was basically of three components: an excess interest, mortality savings, and, very rarely, an expense saving can be found.

Mr. JENKINS. Are you saying that all dividends should be deductible?

Ms. NIELSON. I am saying theoretically, the approximation I gave is an estimate of the equity return in that dividend. As a practical matter, it is very small.

Mr. JENKINS. You do not agree with Mr. Chapoton on the direction that the administration is going with deductibility of dividends?

Ms. NIELSON. The primary concern I have seen in visiting with members of the industry are not the theoretical accuracy of such a deduction, but rather the flexibility—the potential for "manipulation." The mutual companies would not object to some reasonable, 5 percent, nondeductible figure. But I think something as I proposed along the lines of an alternative minimum tax that would prevent the companies from "zeroing out" their taxes, which is an option that the stock companies would not have——

Mr. JENKINS. Would there be any concern about the distortion of an old-line company that had income coming in from the policyholders where the policies had been sold over a period of years, and a new company?

Ms. NIELSON. The new company is going to have much higher expenses, and I doubt if it will have an operating income from which to deduct. A typical life insurance policy doesn't make a profit for 7 to 10 years—the garden variety policy, that is to use one of the Secretary's terms.

Mr. JENKINS. So a new company and a small company would have a very difficult time in surviving if we do not make some allowance for adequate reserve or some considerations for them?

Ms. NIELSON. The nature of the policy is that the expenses, especially with a net level premium reserve, associated with the policy issue exceed the premium by 40 to 60 percent as an average.

Mr. JENKINS. It seems to me that most policies are sold with most of the premium for the first year or two going to the agent. Does that make a difference in what we do as far as tax policy is concerned with new companies or small companies?

Ms. NIELSON. I would not think so. They are expenses of doing business and I do not see how you can disallow them to anyone.

Mr. JENKINS. Thank you.

Chairman STARK. I want to thank this panel very much. I think that you have given us a good many new ideas to consider. As you have a chance to reflect on Secretary Chapoton's testimony this morning and that of the GAO and others, any further ideas that any of you might want to direct toward this subcommittee, will be very much appreciated. And I appreciate very much your taking the time to be here today.

I have an announcement for those past witnesses and for those witnesses for the remainder of the hearing, and those tomorrow and those representing the witnesses. You all have stirred up a great deal of interest in the financial press, and in a word, your testimony is going like hotcakes. A large number of extra copies would be appreciated by the fourth estate, and we would recommend at least an extra 50 copies for you to get the exposure you deserve for your deathless prose. If you would leave it at the press table, I am sure it would be greatly appreciated by the press, the staff, and the Xerox Corp.

The committee will stand in recess for approximately 10 minutes, at which time we will ask the ACLI, the American Council of Life Insurance, to present their testimony.

Thank you very much.

[Recess.]

Chairman **Stark**. If our guests could make themselves comfortable, the hearing will resume and the panel representing the American Council of Life Insurance, Richard Minck, the executive vice president for government relations, and Dr. Gerard Brannon, the director of special projects, namely taxes, have agreed to testify on a limited area.

I have asked the American Council to address a specific question dealing with the revenue shortfall that came up out of the 1982 estimates. I will repeat this again, before the members ask questions, that we have agreed with the American Council of Life Insurance to limit our questions to issues of aggregate revenues and questions of that type because of a lack of unanimity among its membership as to the best action to be taken by the subcommittee.

I would encourage the witnesses to respond to any question that they feel is not in keeping with our agreement by crying foul or off-limits or whatever, fault, as the case may be, and proceeding to the next question.

Having said that, we welcome both of you to the subcommittee and would like to let you proceed to summarize your testimony in whatever fashion you desire.

STATEMENT OF RICHARD V. MINCK, EXECUTIVE VICE PRESIDENT, GOVERNMENT RELATIONS, AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY GERARD M. BRANNON, DIRECTOR, SPECIAL PROJECTS—TAXES

Mr. **Minck**. Mr. Chairman and members of the subcommittee: Thank you very much.

As the chairman indicated, I am Richard Minck from the American Council of Life Insurance, and with me is Dr. Gerard Brannon. We are here to testify on those specific matters. We are grateful for the assurances the chairman gave and his kindness in repeating them at the beginning of our testimony.

We would like to limit our testimony to the subject of tax estimates. We are sure you will receive testimony from individual life insurance companies and they may express somewhat different views on some matters as to how life insurance companies should be taxed. So we would appreciate not getting into such matters.

What I would like to do is briefly to summarize our written submission. In the first 4 or 5 pages of that submission, we discuss the methods that were used to project tax revenues last year by the Treasury, by the staff of the joint committee, and by our own staff, and the reasons why the traditional methods produce estimates that were too high.

We also discuss in those pages alternate techniques that we have been using in order to improve the estimates. We would be happy to continue the discussions we have already started with the members of the Treasury and the joint committee staff who are responsible for making those sorts of estimates. We will share with them information we have obtained from our member companies to help in the estimating process.

And then, after we have gotten through those 4 or 5 pages of background, we get into specific responses to the four questions in Chairman Stark's letter. The first one, as we understood the thrust of it, was to determine what components primarily affected the tax revenues and to what extent the deviations from expected results in those components caused the differences in the estimates last year and this year of 1982 taxes.

Under stopgap the overridingly significant component is company profits or, if you prefer, gains from operation. If you look back to the last decade, say from 1975 to 1979, gain from operations was growing at a rate of about 15 percent per year. After 1979 ended, both stock and mutual companies showed a flat or slightly declining profit curve. That was a very drastic change from prior experience.

Early last year when the stopgap proposals were made, we were aware of the financial results for 1980. We shared at that time the general expectation of economists around the country that there would be an early recovery, and we looked for a resumption in growth of profits to the pre-1980 level.

This is not a problem that is limited to the life insurance business. We understand that if you look at last year's Treasury Department projection of 1982 tax liabilities for all corporations and this year's, there was a fall of about 30 percent. The drop is almost the same percentagewise as the difference between last year's projections for the life business 1982 liabilities under stopgap and the current year's.

Those estimates last year did assume recovery taking place, and if there had been such a resumption in profit growth we think the taxes that would have been incurred in 1982 by the life companies would have been about a billion dollars more than we now think they, in fact, were. This was the major item in the differences.

The difference, however, was also affected by increases in what companies invested in tax-favored investments, for example real estate, deep discount bonds, safe harbor leases, that sort of thing. We have asked the companies involved and their responses to our questions suggest that the increase in tax-exempt income for the year was about $400 million more than you might have expected from preceding years' performances, which would have resulted in taxes of about $200 million to perhaps $300 million less than if investments had not gone into that area.

Chairman STARK. Are you referring there to municipals or are you also referring to the effect of safe harbor transactions?

Mr. MINCK. Everything: Safe harbor leases, deep discount bonds, municipals, real estate, the whole shooting match.

In your second question, you indicated that revenues had been expected to increase by about $1.2 billion under TEFRA in 1982. Our baseline estimate for 1982 of $1.7 billion if the old law had been retained with no change and if Modco had been allowed to continue was simply too high.

When we estimated the revenues for TEFRA, the best basis we had to estimate 1981 taxes was by tabulating the results reported in the annual statements that had been filed with the State insurance departments around March. Those indicated a tax of about $1.7 billion for the year. When companies in the late fall of 1982 actually filed their tax returns for 1981, the returns showed a tax liability of about $1.2 billion.

In retrospect, then, stopgap legislation significantly increased the taxes, but the taxes started from about half a billion lower than we had any way of knowing they were starting from. We do not think the reduction in tax revenues from 1982, that is the change between last year's estimates and this year's estimates, are materially related to the TEFRA provisions. We think that the predictions of the tax effect of TEFRA by the Treasury, the joint committee, and by us were fairly well borne out.

You also asked about the safety net provisions or the release of nontax contingency reserves related to Modco and whether that resulted in an increased policyholder dividend distribution. We do not have specific information about the impact of either of these two items.

From the annual statements filed with State insurance departments for last year, which were filed in March of this year, we have picked up the growth in dividends to policyholders in aggregate that were paid by the companies. We cannot tell you how much was due to what. That growth was about 3 percent for 1982 over 1981. That is really the best handle we can give you on that question at this point.

Your third question referred to other coinsurance arrangements involving the use of special deductions, section 818(c)(2), and how that might relate to the difference in revenue between last year's estimate and this year's estimate.

The use of reinsurance in order that companies could avoid not losing 818(c) deductions goes back well before TEFRA. We have no indications in the aggregates that we have, in either tax returns or company estimates, that use of coinsurance for that purpose has expanded. It was going on before TEFRA, it is still going on to some extent, and we do not think its use has been affected materially by TEFRA.

We have heard some rumors of possible reinsurance arrangements involving offshore companies. We do not know if this is an insurance problem or a foreign income problem.

We have heard of techniques to inflate the nonpar special deduction that the Secretary talked about earlier today. This possibly has occurred, but in aggregate the tentative nonpar special deduction for the companies as a whole has not increased rapidly in recent years.

You asked about the impact of the consolidated return rule in TEFRA so that consolidation was bottom line rather than phase by phase. We think that in general that has had relatively little impact on the 1982 tax returns, because under TEFRA the phases are not very important. Most of the taxes are being paid basically on gain from operations, without regard to taxable investment income.

The bottom line approach does permit some greater use for those companies who are in a phase 2 positive situation, that is, where there is some deferral. But as far as we know that situation really did not change much from 1978 to 1982.

The fourth question you asked was, what ongoing information gathering efforts are we making to improve the estimates. We were—in the discussion earlier of the way the estimates had been made, we talked about the technique of taking historical figures and projecting trends in growth rates.

That technique broke down pretty badly. We have tried to improve our results by going to our member companies and getting them to estimate revenues for us. We have developed a three-page information return which we call a semiannual estimate of tax. We collected about 100 of these returns in the fall of 1982. We have sent out requests for new returns in this spring. We intend, as I say, to do it every 6 months or so.

The sample that we got consists of companies that pay more than two-thirds of the taxes paid by life insurance companies, therefore it is statistically significant. We got considerable information related to tax calculations for the years 1982 through 1984 under both the stopgap formula and the permanent formula. We can check a lot of that against other information sources, specifically against annual statements.

In order to assess these, we put together a committee of company people to meet periodically with our staff to review the revenue estimates. We have that committee balanced between stock and mutual companies, the stock companies looking at the mutual companies' estimates and the mutual companies looking at the stock companies' estimates. So we feel relatively comfortable that they are being reviewed by an impartial audience.

And we have already shared tabulations of those returns with the Treasury and the committee staff. We propose to continue to do that, to try and help the whole estimating process.

With that, I think Dr. Brannon and I would be delighted to try to respond to any questions you may have, Mr. Chairman or from members of the committee.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE, PRESENTED BY RICHARD V. MINCK

Mr. Chairman and members of the subcommittee, I am Richard V. Minck and with me is Dr. Gerard Brannon. We are both members of the staff of the American Council of Life Insurance, and we are here to testify with specific reference to revenue estimate matters as requested in the letter of May 2 from Chairman Stark to Richard Schweiker. The American Council of Life Insurance ("ACLI") is a trade association representing 577 life insurance companies which, in the aggregate, account for approximately 96 percent of the life insurance in force in the United States and hold 97 percent of the assets of all United States life insurance companies.

We will respond to the specific questions in the May 2 letter (our responses are in a slightly different order from the questions, but we think our presentation will be easy to follow). We will also try to answer fully any further questions you might have with regard to these matters.

We were grateful for the assurances given by Chairman Stark in his letter that our testimony could be limited to these revenue estimating matters. You will receive testimony from individual life insurance companies who may express different views on some matters of policy as to how life insurance companies should be taxed. At this time, our member companies have requested that ACLI not testify on matters of policy in order to avoid creating false impressions as to whether or not a consensus exists on some of these matters.

The Congressional Committee Reports published when TEFRA was enacted contained revenue estimates showing the life insurance industry tax liability for calendar year 1982 at $2.9 billion. It now appears that liability will be in the neighborhood of $2.0 billion.

The $2.9 billion projection used by the Committee was the result of information given to the Congress by the life insurance industry, particularly by the ACLI. It is, therefore, very understandable that the Committee should ask "What happened?"

First, let me make some general observations. The recent business recession hit all corporations hard in 1982, including life insurance companies. The Treasury Department's projection of 1982 tax liability for all corporations was reduced between the winter 1982 estimate and the winter 1983 estimate by about 30 percent—practically the same percentage decline in the estimates of the life insurance industry's tax liability. In the past, because of the unique structure of the 1959 Act, a large percentage of tax revenues from the life insurance industry were not sensitive to short term changes in the economy. Under stopgap, most life insurance companies are taxed on their gain from operations—this means that declines in profits result in declines in tax revenues. Large losses in health insurance reduce the tax base. When policyholders borrow on their insurance policies at very low rates, tax revenues fall. When companies reduce prices and increase benefits to policyholders, tax revenues fall.

Let me make another general observation before specifically answering the questions. Although life insurance companies taxes under stopgap were responsive to the business recession in 1982, the share of all corporate taxes borne by the life insurance industry in 1982 were 5 percent of corporate taxes for 1982 as contrasted to a range of 2 percent to 4 percent that had been paid under the 1959 Act from 1960 through 1978.

Before getting into more detail about the specific numbers, we would like to offer some background on the method of making revenue estimates and on our reliance on material from companies.

When we estimated revenue effects of life insurance company tax provisions in 1979, we used what might be called "Treasury methodology." This was to start from a model based on information taken from tax returns for a base year and then to "blow up" various components of this model using a growth rate appropriate to each component. (When Treasury makes an estimate for, say, increasing the personal exemption, it starts with its tabulation from tax returns for the most recent available year of exemptions claimed at each income level. Then it adjusts its model for increase in population and for increases in income levels.)

As of 1979, ACLI had a rich source of data taken from tax returns of life insurance companies through 1977. Treasury and Congressional staff revenue estimators were working with less data since the government program ("Statistics of Income") collected little detailed data on life insurance companies. ACLI collected copies of tax returns from companies accounting for about 90 percent of the tax, but it took far more detailed information from these returns than the government does. Since then, we have made our data base available to the Treasury and to Congressional staff estimators. Further, the Treasury has initiated a program for tabulating more detailed data from life insurance tax returns for 1978 and 1980. The Treasury tabulations include some details not in the ACLI data and miss other details that ACLI picks up. The two data tabulations will significantly reinforce each other.

The interesting thing about these early revenue estimate efforts was not the data sources used but rather the results. Initially they produced remarkably accurate projections.

When we collected tax returns for 1978, they reported almost exactly what we had projected using Treasury methodology and 1977 data. The industry assets were growing about 10 percent a year, and its rate of return on investments was growing about 6 percent a year. This meant that the tax base (which was mostly investment income) was growing about 16 percent a year. This was the rate of growth annually from 1975 through 1977, and we were right to predict this growth in the tax base of 1978. When the tax data for 1979 came in the results were lower than projected figures using this basis. The growth rate over 1978 was only 8 percent instead of the projected growth of 16 percent.

We knew from general discussion in the industry that there had been some Mod Co transactions in 1979 and many more in 1980. As things developed, industry taxes went down about 30 percent in 1980 below 1979, rather than continuing to grow.

Thus, the technique of projecting tax revenues by using trends in income simply broke down. We could not answer the question, "what would have been the tax without Mod Co.?"

One approach to estimating the basic structure was to go back to "Treasury methodology" and project growth from 1978 at something like the old 16 percent per year rate, guessing that the lag in 1979 was due to the impact of Mod Co. This is substantially what we did in 1981 when we projected revenue for the long range reforms we had recommended to the Congress in 1981. In the winter of 1981-82, the GAO made a report to the Congress on life insurance company taxes. They were faced with the same revenue estimating problem, and they used the same technique that we had used earlier, projecting increases from the 1978 levels using the old growth rate.

By the end of 1981 we at ACLI realized that the "Treasury methodology" was producing substantial overestimates of the potential tax liability of life insurance companies. Too much was changing in the economy and in the insurance business to rely on trend projections.

At this point it is useful to respond to your question No. 4 about estimating methods:

What ongoing information-gathering efforts is the ACLI making to more precisely project future industry trends?

We have tried to improve the process of obtaining revenue information from the companies. Specifically, we developed a 3 page information return which we call the Semi-annual Estimate of Tax (SET). We collected in excess of 100 usable SET returns in the fall of 1982, and we have sent out requests for new returns this spring. The companies responding pay more than two-thirds of the taxes paid by life insurance companies, so that the sample is statistically significant. The form asks for considerable information related to tax computation for years 1982 through 1984 under both the stopgap and the permanent formulas.

This approach, by the amount of detail that it calls for, lends itself to a good deal of checking against other information sources (e.g. Annual Statements). In order to exploit these possibilities, we have organized a Committee of company people to meet periodically with the ACLI staff to review revenue estimates. Much of what follows is based on SET's we have collected. We have already shared tabulations of SET returns with the Treasury and Committee staffs.

Now we turn to your specific questions about revenues. When the Committee acted on TEFRA in 1982, it was expected that life insurance companies would have liability for calendar 1982 of $2.9 billion, which was $0.2 billion over the industry proposal, which in turn was $1.0 billion above the Treasury estimate for prior law, $1.7 billion. Now it appears that the industry liability for 1982 will be about $2.0 billion.

The thrust of your first question as we read it is to determine what components primarily affect the tax revenue, and to what extent did deviations from expected results in those components cause the difference in tax revenue. Under stopgap, the overridingly significant component is company profits, or gain from operations. Historically, (in the years 1975-79) gain from operations was growing 15 percent per year. Both stocks and mutuals showed a flat or slightly declining profit curve after 1979, a result very different from prior experience. As of early 1982, when the stopgap proposals were made, we were aware of the 1980 lag, but we shared the general expectation of early recovery, and we looked for quick resumption of the pre-1980 growth. We understand that the Treasury Department projection of 1982 tax liability for all corporations fell between the winter 1982 estimate and the winter 1983 estimate by about 30 percent, almost exactly the same as the projections for the life insurance business. Our estimates did assume recovery taking place and a resumption in profit growth by the companies, which would have produced perhaps another $1.0 billion.

While this was the major item, the difference was also affected by increases in the amount of tax favored investments, such as real estate, deep discount bonds, safeharbor leases, etc. Direct questioning of a number of companies suggested that the increase in such tax-exempt income could be $400 million, which would reduce taxes by about $200 million.

In your second question you indicated that revenues were expected to increase $1.2 billion under TEFRA in 1982. Our base line estimate for 1982 of $1.7 billion was simply too high. When we estimated revenues for TEFRA, the only reading available for 1981 taxes was the estimate reported in the Annual Statements (filed with the State Regulators around March) which indicated a tax of $1.7 billion. When companies filed tax returns for 1981, the return showed a tax liability of about $1.2 billion. In retrospect, then, stopgap legislation significantly increases tax but from a lower base level than we had estimated.

Thus, it does not appear that the reduction in tax revenue for 1982 is materially related to TEFRA provisions. Rather, the tax effect of the safety net was fairly well predicted.

You also asked whether the saftey net provisions or the release of nontax contingency reserves related to Mod Co resulted in increased policyholder dividend distribution. We don't have any specific information detailing the impact of either of these items but the overall growth in policyholder dividends was modest, rising 3 percent over 1981.

Your question number 3 refers to other coinsurance arrangements involving the use of special deductions or section 818(c)(2) reserve computations, as they might relate to the revenue difference. The use of reinsurance to avoid wasting 818(c) deductions pre-dated TEFRA and we have no indication that it has expanded.

We have heard rumors of possible reinsurance arrangements involving off-shore companies. We do not know if this is in any way an insurance problem or merely a foreign income problem. We have also heard of techniques to use reinsurance to inflate the nonpar special deduction. This may have occurred, but, in aggregate, the tentative nonpar special deduction has not increased more rapidly than the growth of business would suggest.

The consolidated return rule in TEFRA (bottom-line rather than phase-by-phase) has a limited tax liability effect in 1982 because the phases are not very important under stopgap. Under stopgap "bottom line" permits some greater use of the 50 percent exclusion and of the special deduction for accident and health insurance contracts and group life insurance contracts, but these were not much different in 1982 from what they were in 1978.

We will be glad to respond in detail, as well as we can, to any questions you may have about the revenue estimates.

Chairman STARK. Thank you, Dick.

One thing that I would like to have clarified. In your testimony you suggest that the recent business recession hit all corporations, including life insurance companies. But I suspect that their premium income has continued its unabated rise, that the earnings on their investment increased in 1982 over 1981, and will in 1983 over 1982.

Where precisely did the recession hit the life insurance companies?

Mr. MINCK. There are two or three things that happened, and what we have available at this point are figures from the SET, the semiannual estimates of 10 that we got from the 100 or so companies. We will have figures from annual statements tabulated within a fairly short period of time.

But in the aggregate, during the last several years gain from operations both before and after dividends to policyholders have been quite level.

Chairman STARK. Let me go back. Premium income has increased, has it not?

Mr. MINCK. It has. Other things have gone up, including claims.

Chairman STARK. As they always have, but they have never gone up to exceed premium income. And investment income has gone up, has it not?

Mr. MINCK. Both have gone up, but again, we have had moneys flowing out in larger amounts because of cash surrenders, claim increases, expenses, a whole series of things. And when you net all of the income and outgo together, before you get to dividends to policyholders, the gain from operations was essentially the same in 1982 as it had been in 1981, 1980——

Chairman STARK. I just want to clarify here. You refer to the 30 percent decrease in corporate receipts and would put the life insurance companies under that. But you are not suggesting to the committee that the life insurance industry had any kind of a 30 percent decline in profits?

Mr. **Minck**. No, sir. What I was suggesting was that if the gain from operations had grown at the rate that it had in the mid and late seventies, we would have had about an extra billion in taxes and not having that increase in operating gains meant about 30 percent less taxes than we had expected.

Chairman **Stark**. I guess what I am suggesting is that the change in revenues was largely due to tax factors and the accounting method by which the tax was calculated and perhaps change in the tax laws, but not in any operational aberration. There was no plague that swept the country, nor excessive air crashes or earthquake disasters or anything of that nature which wildly skewed either the earnings or expenses of the companies.

Mr. **Minck**. No. I think that you are exactly right, there has not been a major change in the gross income. But the taxes, of course, are levied against something that——

Chairman **Stark**. I understand that. I just did not want to say that they have had a famine year after a bunch of feast years.

Mr. **Minck**. Dr. Brannon would like to add to that.

Mr. **Brannon**. I would like to add a couple of points to that. When you are talking about profits, of course, you are talking about the difference between income and outgo, and small changes on those big numbers can make quite a difference in the profit.

One thing that has been very important in the life insurance situation is the general development of financial competition. We are talking about the period since 1978. We have had interest rates going up a great deal; a lot of relatively new institutions that are able to invest at current market rates, money funds and so forth, constitute the competition.

Life insurance companies, with a lot of very old investments, going back to the sixties and seventies when rates were much lower, have had to compete with these new institutions. So that in the marketplace you find this increased competition forcing companies into paying larger returns to keep the money. This cuts into profits.

Chairman **Stark**. Thank you.

Mrs. Kennelly I think touched on earlier which companies have been the primary beneficiaries of the deferral of underwriting income. To the extent that you have a breakdown on how that is distributed among companies, it would be useful information. And to the extent you can share that with us, we would appreciate it.

Mr. **Minck**. We would be happy to try. We can make a couple of observations now. The way it comes out are two sources: One—well, in each case you have to be in a situation where your operating gains are appreciably larger than your taxable investment income, and there are two sorts of situations that that comes about:

One is where you are writing a lot of insurance that is essentially term in nature, group insurance for example, companies that have a very large operation there as compared with their others, and by that I meant the regular group insurance.

The other situation is, credit life insurance tends to be of the same nature, and there are companies for whom that is an important part of their operations. Generally, it is companies in that situation that have operating gains far greater than taxable investment income.

We do not have with us a breakdown, but we will certainly provide you with whatever we can.

[The following was subsequently received:]

The most comprehensive data on the deferral account is provided by a tabulation of data from all life insurance company tax returns for 1978 which has been provided to us by the Treasury Department. The cumulative deferral account is called "the Policyholder Surplus Accounts." The following table relates to size of assets both: (1) the gain or loss from operations before special deductions but after policyholder dividend deductions; and (2) the policyholder surplus accounts.

[Dollars in millions]

Size of assets	Number of companies	Assets	Gain or loss from operations	End of year policyholder surplus accounts
Below $0.1	67	$3.3	$2.7	$3.6
$0.1 to $0.5	101	18	1.7	2.6
$0.25 to $0.5	130	47	3.7	6.6
$0.5 to $1	143	106	8.2	13
$1 to $10	591	2,277	70	211
$10 to $50	320	7,469	99	482
$50 to $100	91	6,459	142	380
$100 to $250	89	14,014	274	522
$250 to $500	42	15,220	330	640
$500 up	56	101,511	1,909	2,981

Chairman STARK. Thank you.

I want to word this question carefully. In testimony that the committee has received in printed form, there was a proposal by a stock company group that they estimated would raise in the aggregate about $2.6 billion. I am wondering if you have reviewed that calculation and, without asking you to comment on the proposal, do you have any information as to how that proposal would spread the burden in the industry? And if you have not done that, if you could do it it would be of some interest to the Committee.

Mr. MINCK. Mr. Chairman, we have not, and——

[The following was subsequently received:]

As discussed in our testimony, we have no good means of predicting the tax base for 1984 other than asking the companies what they think will happen. Based on the answers we got about the operation of the permanent provisions in 1984, we think that "more than $2.6 billion" is a reasonable estimate for the stock company proposal.

Our company projections suggest that the permanent provisions in 1984 would produce $2.1 billion from mutual companies and $1.2 billion from stock companies (where stock subsidiaries of mutual life insurance companies are included with the mutuals). The mutual tax would be reduced by about $0.3 billion as a result of the more severe Phase I deduction for group pension plans and the more generous geometric 10/1 rule. The stock company tax would be reduced by about $0.2 billion by removing the special deductions from the Sec. 809(f) limits and about $0.1 billion by the changed Phase I deductions. These calculations suggest a net tax of $1.8 billion mutual, $0.9 billion stock for a combined $2.7 billion with 67% of the revenue from mutual companies.

Chairman STARK. And I would invite, as a matter of fact, your comments on the burden spreads in any proposals that come before this committee that you feel are appropriate. As I say, I know that you cannot comment on the desirability of it, but I think if we could ask you for your empirical calculations that might fall within the scope of the neutrality bounds that we laid down.

Mr. **Minck**. Yes, sir.

Chairman **Stark**. The other question in regards to asking you for information concerns your Life Insurance Fact Book. In that book there is a summary and an analysis of ordinary life insurance purchasers, and it includes information on the income of the insureds and the policy size and type of policy.

Because of a variety of suggestions that the company tax rate should be lowered to reflect tax burdens in the hands of a policyholder, could you give us some background data or methodology in this table calculation and any information on higher levels of income or how that income was measured? If you could expand on that in any way, it certainly would be useful as a tool for us as we try to measure the various impacts of proposals that the Committee is studying.

Mr. **Minck**. Mr. Chairman, we would be happy to share any information we have with the committee on that subject.

[The following was subsequently received:]

There is no very good data on the distribution of ownership of cash values in life insurance reserves by income level.

In 1976 the American Council of Life Insurance and the Life Insurance Marketing and Research Association undertook a national survey of 3,097 households the results of which were published as "A Profile of Life Insurance Ownership in the United States." The most important finding of this survey, is captioned in the following extract from "Profile" (p. 62).

Regular life insurance ownership of adult males

Total household income	*Mean coverage*
Under $6,000	$9,000
$6,000 to $9,999	7,180
$10,000 to $14,999	15,100
$15,000 to $19,999	17,590
$20,000 $24,999	23,640
$25,000 up	41,610

It would not be a bad approximation of the data in this table that life insurance coverage in each income bracket is close to the mean income in that bracket. In other words, life insurance ownership is spread about the same way as income.

Chairman **Stark**. If we can ask your indulgence, we have 7 minutes remaining on this vote and several of the members have some questions.

The committee will recess for 7 minutes.

[Recess.]

Chairman **Stark**. Unless the witnesses at the table have negotiated an agreement among their clients in the recess, I would ask them to come back to the witness table.

Mr. **Minck**. We have not quite succeeded, sir.

Chairman **Stark**. Mr. Duncan.

Mr. **Duncan**. I do not have any questions. I thank the panel for being here and helping us.

Chairman **Stark**. Mr. Flippo wanted to inquire.

Mr. **Flippo**. Yes, Mr. Chairman, I do have a question.

I notice on the top of page 3 that you reported that the percentage of corporate taxes borne by the life insurance industry went up to 5 percent in 1982, as contrasted to the 2 to 4 percent from 1960 through 1978. And I had a question or two about that.

Is that because all corporate taxes went down, or did we actually have a significant increase in corporate taxes in the industry?

Mr. **Minck**. I believe that what happened was that corporate taxes went down very considerably in 1982.

Mr. **Flippo**. Then the other question, I notice that 1979, 1980, and 1981 were left out in the discussion or the range of 2 to 4 and up through 1978. I think my concern—all of us are concerned about trying to have legislation that is equitable and fair and reasonable,

But I notice that it is very difficult to try to find out what is going on in the industry, and I notice that you stated on page 6 that you had 100 usable sets of returns. And it occurs to me there must be what, more than 2,000 companies? And you are dealing—your response here is 100 useable sets.

I guess my question concerns the data base that we are trying to do something with here. Are there problems associated with your sharing the information that you have with the tax estimating staff? I guess what I am interested in is in some study or exploring some way that we can get a good reliable data base. And since you have more than 2,000 companies and only 100 usable sets, I wonder if it might be appropriate for you to supply us the names of those companies who have not furnished those sets, not in a formal way but perhaps share it with the staff.

I am really trying to get to the fact base. It is hard to design something that has an illusive fact base.

Mr. **Minck**. Yes, sir. I think that, while there are 2,000 life insurance companies, the 100 companies that we had usable returns from constituted—or pay in the years that we have figures for more than two-thirds of the taxes paid by the business. So statistically, if you are blowing it up from that base to the full universe, it is a pretty reliable source.

We have been happy to share information with the Treasury revenue estimaters and with the estimaters from the joint committee staff. We can aggregate the information in any useable form for them and we will be happy to continue to do so.

Mr. **Flippo**. Well, the disaggregated information it seems to me might be of some usefulness as well. But anyway, I did want to express my concern.

In the interest of time, Mr. Chairman, I will stop at that point.

Mr. **Guarini** [presiding]. Any other questions? Mrs. Kennelly?

Mrs. **Kennelly**. Mr. Minck, I think some of us are trying to get at the same answer, but coming from different directions. We have established that there was a revenue shortfall, and I think one would have to conclude that there are either changes occurring in the insurance industry that makes it almost impossible to have tax projections according to historical data, or that the tax law allows a great deal of tax avoidance?

We have the shortfall. We have the actual figures you gave. We have the actual figures. Now, is it possible to come up with correct estimates?

Mr. **Minck**. The only basis that we have found that we think is better than the historical basis is to go to the companies directly and ask them to make estimates. As you say, there are a lot of different things going on within the business and within the economy that make the estimating business an awful lot harder than it was, say 5 years ago.

For example, 1981 tax returns were under the old law, existing law. Companies had to make estimates as to what their taxes would be for 1981 when they filed their annual statements in March of 1982 with the State insurance departments. Their best estimates at that point were, as I have indicated in my testimony, about $1.7 billion.

When it came time in August or September to fill out the Federal income tax returns, they actually found that they had a liability of $1.2 billion rather than $1.7 billion. Now, that is off by 30 percent. And all of the events for the tax year had occurred before March of the following year. It is just that the complexities of the thing and the change in operations made it very hard for the tax estimaters within the companies to get figures as reliable as they were able to produce several years ago.

So again, our only source that we can improve on is to go to the companies and ask them to do the best they can.

Mrs. KENNELLY. Maybe I could put it another way. Do you think just in this year's experience that you can see that tax revenues were reduced either by payouts in policyholder dividends or by bottom line consolidation? Can you see evidence of this?

Mr. MINCK. No, we saw nothing in what we had to date that showed major change in tax revenues from either of those two sources from 1982. Dividends may change this year, but again, in the aggregate dividends went up about 3 percent in 1982 over 1981 for the industry as a whole. The tax result would not be very great from that sort of change.

Mrs. KENNELLY. Let me go back a little more in your testimony. I get the impression that taxes increased during the seventies because income increased? Is that a correct statement?

Mr. MINCK. Yes, ma'am. Taxes went up much faster than income did through about 1978 or 1979 because of the old law.

Mrs. KENNELLY. I know we have ground rules here and just tell me no if you cannot answer it. But can you give me the answer to the question of what is the effective tax rate right now for the industry?

Mr. MINCK. I think that there are probably two sets of figures I can give you that would shed some light on it for 1982. One is gain from operations before dividends to policyholders, and the other is gain from operations after dividends to policyholders; and finally, corporate income taxes, with the idea that one way of measuring the effective tax rate would be to relate the corporate tax to the profits or operating gains of the companies both before and after they paid dividends to the policyholders.

The reason for approaching it that way is that it is the question of dividends to the policyholders that makes the response so difficult.

[The following was subsequently received:]

Herewith are some numbers on taxes, and gains from operations before and after dividends as reported to state regulatory authorities. All of these numbers vary from tax return data, especially the tax figure which is affected severely by tax reserves.

NET GAIN FROM OPERATIONS BEFORE FEDERAL INCOME TAXES

	Policyholder dividends—		Taxes
	Before	After	
1978	$13,560	$7,059	$2,972
1979	15,179	7,977	3,261
1980	15,087	7,552	2,525
1981	14,773	6,459	1,703

Source: ACLI.

Mrs. KENNELLY. So we don't know yet what the effect of TEFRA was. I do not think we have really got that down yet.

Mr. MINCK. The effect of TEFRA I think was to result in an increase in taxes of nearly a billion dollars as opposed to what would have been paid if TEFRA had not been enacted. I do not think that is any great disagreement among the people who do the revenue estimates.

Mrs. KENNELLY. And yet you tell me that payout, policyholder dividends, and bottom line consolidation were not affected by TEFRA?

Mr. MINCK. That is right. What happened was that TEFRA did two things: It got rid of Modco, which increased taxes——

Mrs. KENNELLY. That is one thing we all can agree on.

Mr. MINCK. And the other thing it did was to permit a greater share of deductions for dividends to policyholders than had been true under the old law. And the net result of those two things, which were the major impacts of TEFRA, was to raise taxes, as I say, somewhere around a billion dollars as compared with where they would have been if TEFRA had not been enacted.

Mrs. KENNELLY. Thank you, sir.

Mr. GUARINI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Just one question. The committee obviously is concerned about revenue estimates and the accuracy of revenue estimates, and that is the reason I believe that the letter was addressed to your organization asking you to respond.

The estimate of $2.9 billion and the anticipated revenue of $2 billion, that is missing by nearly a billion dollars. That is of concern. On page 2 you talk about the Treasury's reestimation of the corporate income tax, suggesting a reduction of its original estimate by about 30 percent, as a corollary to something that might have happened with respect to your revenue estimating.

As I understand it, the Treasury Department not only overestimated and seriously miscalculated the rate of growth in the economy, but also really missed it on items like leasing and a number of other areas of tax law. So I think the Treasury reestimate is simply a recalculation based on flat-out errors they made in calculating the effects of the 1981 Tax Act particularly. So I am just suggesting, do not hook too tightly your performance on Treasury's performance with respect to Treasury's recalculation with the 30 percent of corporate income tax revenue.

Mr. MINCK. No, sir, we did not intend to imply anything other than that there were things going on in the economy, and it did not perform as well as anyone had expected. That sort of thing had impact not only on the general corporate estimates, but also on ours.

Mr. BRANNON. But some of those Treasury considerations were involved in our case, too. You did make actions, legislation about leases, and that applies to life insurance companies as well as other corporations.

Mr. DORGAN. I understand that. But we are really talking about your forecast to the committee relative to the performance, and that was why the committee was interested. But I appreciate your answer.

Chairman STARK. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Regarding the shortfall, I would assume that during a 2-year period of extended recession you had policyholders borrowing from the company to a greater extent than ever before. Is that not correct?

Mr. MINCK. Yes, sir, both borrowing and surrendering their contracts for cash.

Mr. JENKINS. And the advent of IRA's and the expansion of other competitive systems, I would assume, would also have an effect on life companies?

Mr. MINCK. Yes, sir, it does. Also, it increases the claims you get for medical insurance and disability coverage.

Mr. JENKINS. And the inflation rate as far as medical costs has not gone down very fast.

Mr. MINCK. Not noticeably, particularly for our claimants.

Mr. JENKINS. So that has continued to hit rather strongly against the insurance companies.

Mr. MINCK. Yes, sir.

Mr. JENKINS. And this is true regardless of whether they be mutual or stock, is that not correct?

Mr. MINCK. It is true across the board.

Mr. JENKINS. Thank you, Mr. Chairman.

Chairman STARK. Thank you, Mr. Jenkins.

Just a couple of questions. Do you have any figures as to the dollars sheltered under 818(c)(2) and how it may be divided among the industry in the aggregate?

Mr. MINCK. Yes. I think that we have some indication of the impact that the election has on the tax base, and if you are interested in the question of how it divides between, say, stock and mutual companies, I think our figures show that it is slightly more of a deduction for mutual companies currently than stock, but fairly evenly divided.

[The following was subsequently received:]

There is no basis for making a precise revenue estimate of the effect of Sec. 818(c)(2) but we can offer some educated guesses.

If we assume a tax formula in which gain from operations is the basic revenue base for most companies (as it would be under a single phase system or under the stopgap formula) the initial revenue impact of repealing Sec. 818(c)(2) would be about $230 mil. Since this is only a matter of timing, the revenue effect would not in the future grow as fast as the level of life insurance business. Under a three phase formula, such as provided by the permanent provisions, in which taxable investment income is the base for companies accounting for most of the tax, the initial revenue effect would be less than half this large.

As to details, the estimate of GAO is that exact reevaluation on permanent insurance would produce the equivalent of adding $15 per thousand rather than $19. Applying this number to new business only produces an initial revenue effect of $100 million for mutual companies and $80 million for stock companies. (In the long run this effect would be reduced as the "run off" with respect to old business begins to reflect this lower rate.

With regard to term insurance, especially decreasing term, the elimination of Sec. 818(c)(2) might produce extra tax of $25 million for mutual companies and $25 million for stock companies, assuming continuation of a gain from operations based formula.

Chairman STARK. Following down that in terms of other breakdowns, would you have any figures as to how those 818(c)(2) deductions are attributable to graded premium contracts, or do you have any data at all on the sales of those as a separate product?

Mr. MINCK. I think that we would have to go back to sources. That sort of stuff is not available, of course, from the tax returns or from the annual statements. But we may have something in our set surveys.

[The following was subsequently received:]

The Senate Committee Report and the Conference "Report" on TEFRA indicated that the Treasury Department should issue regulations to the effect that certain "graded premium" policies that did not generate significant cash values in the early years should not be treated as permanent insurance for purposes of Sec. 818(c)(2). That regulation has not been issued. If it is issued, and if it stands up to court review, then the answer to your question is "zero." A rough estimate is that the regulation would increase the life insurance company tax by about $100 million.

Chairman STARK. I guess just to wrap that up, if we are unable to determine from the information that we have as to the dollars going into the various types of products—and I do not mean just generally term or ordinary, but particularly with respect to annuities or deferred annuities or graded premium or newer types of products—and if you have any of that information, again in the aggregate, it would be useful to us.

I want to thank you both. We have enjoyed your assistance, and I know the various staffs involved in this have worked, and I hope we will be able to continue to work with you and get your unbiased, at this point, suggestions, and perhaps look forward to the day when you can be an advocate once again. [Laughter.]

Mr. MINCK. Mr. Chairman, we thank you.

Chairman STARK. We now are able to call the panel of witnesses that I think of as the mutual company executives committee.

That is comprised of: Robert Van Fossan of the Mutual Benefit Life Insurance Co.; and John Creedon of the Metropolitan Life Insurance Co.; and James Martin of Massachusetts Mutual Life Insurance Co.; Walter Gerken of the Pacific Mutual Life Insurance Co.; Coleman Bloomfield of the Minnesota Mutual Life Insurance Co.; and Mr. G. Frank Purvis of the Pan-American Life Insurance Co. of New Orleans. I also notice Messrs. Zinn and Groom, their counsel.

I hope they can get their feet under the table, which is not quite big enough to accommodate all of these distinguished gentlemen. We apologize. I am going to just kind of hold off here for a minute or two so that the rest of our committee can return from this vote.

Again, I apologize for holding you until this late hour, but you were one of the large thick bundles of testimony that Mrs. Kennelly referred to, and I think we will let you start.

I notice that I have oral statements here which are your summaries. Proceed in any manner that you all would like.

Bob, are you going to lead off?

STATEMENT OF ROBERT V. VAN FOSSAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MUTUAL BENEFIT LIFE INSURANCE CO., NEWARK, N.J., AND CHAIRMAN, MUTUAL COMPANY EXECUTIVE COMMITTEE, ACCOMPANIED BY MATTHEW J. ZINN AND THEODORE R. GROOM, COUNSELS

Mr. **Van Fossan**. Yes. Thank you, Mr. Chairman.

I am Bob Van Fossan, chairman and chief executive officer of the Mutual Benefit Life Insurance Co. I also serve as chairman of the Mutual Company Executive Committee.

Chairman **Stark**. I might add, by the way, that you are also one of the groups that we had determined we did not really care to rush through on strict observance of a 5-minute limitation. So that in view of your size and importance in the industry we thought we might make that 6 or 7 minutes. But go ahead and take your time. [Laughter.]

Mr. **Van Fossan**. We appreciate that, Mr. Chairman.

As I said, I am also chairman of the Mutual Company Executive Committee, which was formed to provide a focal point for formulating mutual company views on permanent tax legislation.

You have already identified my associates today, so I will not do that. My colleagues and I appreciate very much the opportunity to share our views with you and the other subcommittee members on the need for a new permanent tax law for the life insurance industry.

Mr. Chairman, before summarizing the major elements of our testimony, let me briefly describe the companies we represent. Mutual companies, as most of you know, operate under cooperative principles. Cooperatives are organizations in which members join together to achieve a common economic purpose. Mutual life insurance companies have as their primary purpose the provision of insurance at cost to our policyholders. Unlike stock companies, we have no shareholders.

Mutual companies, we would suggest, play a major role in providing all forms of life insurance, individual and group, to millions of American families and in providing needed capital for our nation's economy. When the tax law was last examined in 1959, mutual companies in our industry were dominant in the marketplace, with more than 75 percent of industry assets and 63 percent of all life insurance in force. We currently have about a 58 percent share of total industry assets and less than 50 percent of insurance in force. It is expected that in 1984 the mutual share of these items will be 54 percent of assets and 46 percent of insurance in force.

The very substantial role of mutual enterprises in the life insurance business is not surprising when one considers the very nature of our business. As the Armstrong Commission said in its report when issued in 1906, the business of insurance is fundamentally mutual, since it involves the pooling of capital and risks of large numbers of people. Also, as that landmark Commission noted, even in the case of stock companies, the capital stock bears an insignificant relation to the resources of the company provided by the policyholders through their premium payments. In fashioning a tax law for life insurance companies, it is important to bear in mind that mutuals are the normative form of organization. We should not be treated as strange animals whose structures should be molded into a world whose population is simply predominated by investor-owned companies.

Mr. Chairman, we have submitted for the record a written statement which sets forth our views in some detail. Also, in order to be directly responsive to the subcommittee, we have attached an appendix to the statement of our specific responses to each of the 24 questions posed in the subcommittee's April 8, 1983, press release. We ask that the subcommittee include these materials in the hearing record.

Finally, let me summarize briefly the five major points that will be covered in the oral testimony by my colleagues on this panel:

First, mutual companies believe very strongly that the 1959 Tax Act has serious flaws and must be replaced. Last year, when a temporary stopgap law was enacted by the Congress, this was the consensus of that Congress, the Treasury, and the entire life insurance industry. Nothing, we suggest, has changed to change that viewpoint.

Second, mutual companies do not believe that the temporary stopgap law should be adopted permanently. It has serious weaknesses that render it unsuitable as permanent legislation.

Third, mutual companies believe that the permanent law should be designed to tax all companies in our business on their true economic income. Such a law would bring our taxation into conformity with the taxation of all other corporations in American business.

Fourth, contrary to the claim of some stock companies, there is no justification, either in tax policy or in fact, for a significant mutual policyholder ownership differential.

Fifth, mutual companies support retention of the current rules applicable to the taxation of policyholders. We feel these rules are consistent with general tax principles and sound public policy. We also support—and we are encouraged to hear the views of both the committee members and other people testifying this morning in this regard—the enactment of a definition of life insurance that restricts the application of these rules only to policies whose predominant purpose is the provision of life insurance protection. That is where it should end. The traditional tax rules should not apply to products that are primarily short-term investment vehicles masquerading as life insurance.

Finally, Mr. Chairman, our testimony can reflect only a summary of our views on this extremely complex subject. We would welcome the opportunity to explore further any of the issues discussed in our testimony.

And with that, I would call on Mr. John Creedon, president and chief executive officer of the Metropolitan, to proceed with his part of the testimony.

Chairman STARK. Mr. Creedon, proceed in any manner you see fit.

STATEMENT OF JOHN J. CREEDON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, METROPOLITAN LIFE INSURANCE CO., NEW YORK, N.Y., ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. CREEDON. Mr. Chairman and other members of the committee:

I very much appreciate the opportunity to testify before this subcommittee. First, let me emphasize, if I may, that Metropolitan Life Insurance Co. is and has been a significant taxpayer. For the years 1978 through 1982, which include the so-called Modco years, Metropolitan Life has paid an average of over $200 million a year or $1 billion in the aggregate.

My impression is that some of the testimony that you will hear tomorrow will suggest that the mutual life insurance companies are seeking to eliminate their tax burden. I do not think that is true. I know it is not true in the case of Metropolitan. We expect to pay a reasonable amount of taxes in the future and have done so in the past.

The most important point I would like to make in my testimony is that the 1959 act applicable to the taxation of life insurance companies is an overly complicated, unworkable, unfair mess. I think the case has already been made for me by you, Mr. Chairman, in your opening remarks, and by Mr. Chapoton as well.

A little over a year ago, the life insurance industry, then in complete agreement, told the full House Ways and Means Committee that the 1959 act was a mess and was a serious threat to the very existence of the life insurance business and what it does in the economy. In the last year, Mr. Chairman and members, nothing has happened to make the 1959 act any better. It is still a mess——

Chairman STARK. Except that it was referred to this subcommittee. [Laughter.]

Mr. CREEDON. Well, so far that has not made it any better. The law is still a mess, and I think anyone who says differently is simply trying to maintain what is basically an unfair advantage. The law is a mess and I would like briefly to describe why.

That the 1959 act is overly complicated requires little testimony, and I would emphasize the words "overly complicated." Obviously, the taxation of products like life insurance, which are very different products in many respects, is going to be complicated law. You are not going to have a very simple law, as has been suggested earlier.

But the 1959 act is overly complicated. Few people really understand it. I understand you yourself, Mr. Chairman, have given it considerable study and I suspect you would agree that it is overly complicated.

It is different from anything else in the Internal Revenue Code. It has three so-called phases, and a particular company can wind up being taxed or not taxed, as the case may be, depending on which phase it happens to be in.

The first phase involves a tax on investment income; the second phase involves a tax on total gain from operations; and the third phase provides a tax haven for some companies.

These companies have a bonanza under which they can defer tax on over one-half their underwriting gain, and, so far, it is my impression that $9 billion of taxable income—let me repeat that, $9 billion of taxable income—has been largely deferred by relatively few companies under this phase. And in response to the questions that have been asked on this subject earlier, the companies involved have been largely stock companies, not mutuals.

The three phases are further complicated by a maze of special deductions, artificial rules and loopholes available only to certain companies that literally defies the imagination.

That the 1959 act is unworkable can easily be demonstrated by the experience of my own company, Metropolitan Life Insurance Co. As incredible as it may seem, Metropolitan's tax returns are still open since 1958, the first year to which the 1959 act applied. And our experience is not unique. So many questions still exist after 25 years that there is no hope to salvage the 1959 act.

That the 1959 act is unfair is also easily proven. First, different companies pay different taxes on their financial statement income. Some companies pay taxes on amounts close to that income, others pay taxes on less than that amount, and still others pay taxes on substantially more than that amount. We have an appendix to our paper showing these results, Mr. Chairman and members of the subcommittee, and the results are clearly unfair.

In addition, companies with the same or similar products are allowed deductions for widely different amounts. These product inequities are unfair, noncompetitive and not in the best interest of consumers. The 1959 act also produces unfair taxes for mutual companies far in excess of their share of the business and their share of the assets in the business.

Mr. Chairman, in developing a permanent replacement for the 1959 act, I hope that Congress will recognize and take into account that in 1959 the life insurance industry paid 2.4 percent of total corporate taxes; in 1978, the percentage had increased by 70 percent to 4.2 percent of total corporate taxes; and as has been indicated earlier, in 1982 our estimate is that the percentage is something over 5 percent.

Mr. Chairman, the 1959 act has been described by the courts and commentators variously, as Mr. Chapoton mentioned this morning by Judge Fletcher, as a "conspiracy in restraint of understanding," a "fantasy world," "a source of confusion and mysticism," and a "technical monstrosity." Only last year, the Congress, the Treasury, the General Accounting Office and the unified industry agreed with this position.

The act defies every basic principle of sound taxation. A tax law should be based on economic income uniformly defined. It should tax profits from similar products similarly. Companies should be taxed on a level playing field. A tax law should be understandable and capable of reasonable administration.

The 1959 act fails on all these counts. It is irrational, overly complicated, and very unfair. We hope, Mr. Chairman, that it is as unthinkable to this subcommittee as it to us to permit a return to the 1959 act by failing to legislate in this area this year.

Thank you very much.

Chairman **Stark**. Thank you.

Mr. VAN FOSSAN. Next, Mr. Chairman, I would like to call on Mr. Jim Martin, chairman of the board of Massachusetts Mutual Life Insurance Co.

STATEMENT OF JAMES R. MARTIN, CHAIRMAN OF THE BOARD, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., SPRINGFIELD, MASS., ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. MARTIN. Mr. Chairman and members of the subcommittee: I am Jim Martin, chairman of Massachusetts Mutual Life Insurance Co., I am pleased to be here today and appreciate the interest and hard work that your subcommittee has already shown in preparing for these hearings.

As you attempt to reconcile the conflicting testimony before you, two questions are certain to arise: Should the stopgap legislation enacted in 1982 be extended for another year or two? Or, second, should it even be made permanent?

The stopgap legislation was an improvement over the 1959 act. It began the process of reexamining the 1959 act and it moved many companies' tax bases somewhat closer to their true economic income. But even as the name "stopgap" suggests, everyone involved in the development of that law intended that the law be temporary. The Treasury Department, the Congress, and the life insurance industry all assumed that prior to 1984 stopgap would be replaced with permanent legislation.

However, if there is not sufficient time to enact permanent legislation prior to the expiration of stopgap extending stopgap would be a necessary evil as compared to allowing the 1959 act to go back into force. What is truly needed, though, is permanent legislation. As you know, any industry is benefited by a stable tax environment. But our industry is unique and has critical needs for predictability that can only be met by permanent legislation. We sell products that are intended to remain in force for decades, for a lifetime. For example, in 1982, my own company paid $143 million in individual policy claims. Of all the thousands of lives that were involved there, on an average those policies had been in force for 32 years each. Thus, in establishing prices for these products today we must estimate the future costs and liabilities that these products will entail, and a significant part of these future costs that we must estimate today is, of course, the future tax burden on those products. Without permanent tax legislation, any estimate of future cost is at best a guess. By impeding rational pricing of these products, such uncertainty harms consumers.

Enactment of stopgap as permanent legislation would also be unsatisfactory. Stopgap does not address the major policy concerns that have been raised by members of the Treasury Department, by Members of the House, and by Members of the Senate. Mr. Chairman, as you well know, these concerns are not going to go away. They include concerns that life insurance companies, unlike other businesses, are taxed on bases other than economic income, concerns that similar products give rise to dissimilar tax consequences, and concern that products which are essentially investments are accorded life insurance treatment.

These concerns are valid and the conclusions are inescapable: Life insurance companies should not be taxed on a basis other than economic income; similar products should not be taxed dissimilarly; and products that are essentially investments should not be permitted to be taxed as life insurance.

Stopgap responded somewhat to these concerns, but it preserves many of the underlying deficiencies that led to the current crisis over the 1959 act.

First, stopgap preserves the phase system with its artificial distinction between investment income and underwriting income. This central flaw is the source of most of the controversy and unintended tax avoidance under the act.

Second, numerous noneconomic distinctions and special privileges continue to favor some segments of the industry over others. As a result, the sale of the same product by different companies can still lead to radically different tax consequences.

Third, an investment contract can still be taxed as life insurance, even though the life insurance benefits that the contract happens to provide cannot justify the cash value that is held in the contract. The stopgap definition of life insurance did not remedy that deficiency.

Fourth, the provisions that are defended as benefiting small companies are not really focused on that end. Permanent law should contain better crafted, more focused provisions that will truly benefit the small companies. They need predictability even more than the rest of us.

And finally, in stopgap, no progress is made toward eventually taxing the more than $9 billion in income on which taxes have been continuously deferred during the last quarter century.

Not only did stopgap preserve these deficiencies; it introduced some uncertainties and deficiencies of its own. Years of controversy will be required before a stock company and a mutual company selling universal-life- type policies will know the magnitude of the competitive advantage that stopgap gives to a stock company. Although stopgap appeared to establish a temporary 7.5 percent advantage to the stocks, they were granted an opportunity to litigate for an additional 15 percent advantage. That is a total of 22.5 percent, three times larger. The mere possibility of an advantage of this magnitude is unacceptable. Congress should not leave this important question to be resolved by the courts. Congress should resolve the question now in favor of no advantage for any group of companies—a level playing field.

So long as deficiencies such as these remain in the law, whether in some extension of stopgap or as a part of legislation intended to be permanent, subchapter L of the Internal Revenue Code is likely to continue to revisit this body like a recurring nightmare. For any life insurance company taxlaw to be considered permanent, it must complete the job that stopgap only began. It must resolve the concerns that have been raised. It must tax our industry on its true economic income.

Mr. Chairman, I ask that I briefly be permitted to address an only indirectly related matter that has come up since this testimony was submitted. It concerns a letter which has only recently come to my attention. The letter has been written to one of our policyholders on a Massachusetts Mutual letterhead by one of our 4,500 agents who have contracts to represent us in the field. I am embarrassed by this letter, as it contains a number of important factual inaccuracies and gross exaggerations concerning life insurance company tax law. I bring this up now because the letter, which again was written by an agent of ours, is being widely circulated by stock company lobbyists as an authoritative interpretation of the stopgap law.

This is ludicrous. It is not unlike finding a private letter that was written in the heat of battle by a line army corporal and then trying to use that letter as though it were an authoritative interpretation of policy that was made by the Department of Defense.

I hope that you will accept our apology for that letter and that you will dismiss it, as we have.

I thank you.

Mr. **VAN FOSSAN**. Thank you, Jim.

Mr. Chairman, I would next call on Walter Gerken, chairman and chief executive officer of the Pacific Mutual Life Insurance Co.

STATEMENT OF WALTER B. GERKEN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PACIFIC MUTUAL LIFE INSURANCE CO., NEWPORT BEACH, CALIF., ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **GERKEN**. Mr. Chairman and members of the subcommittee, my name is Walter Gerken. I am chairman and chief executive officer of Pacific Mutual Life Insurance Co., headquartered in Newport Beach, Calif. It is a pleasure for me to be here today. I appreciate your efforts to understand the Byzantine law of life insurance company taxation.

I would like to explain why a tax based on economic income would eliminate the inequity and confusion in the current law.

First of all, such a tax base could be much simpler and still deal with all aspects of a company's operations. It would also base the tax, like other taxpayers' takes, on receipts minus costs of operations.

The 1959 act does require our receipts to be included in income, but its treatment of our cost of doing business is absurd. Under the act, some companies deduct more than their true costs; they are undertaxed. Others are taxed properly. Still others cannot deduct all of their actual costs of doing business. These companies, including almost all mutual companies, are therefore unjustifiably overtaxed and are placed at a serious competitive disadvantage. This is wrong and an economic income tax base would correct it.

Two of a life insurance company's most significant costs of business deserve special comment. The first is providing policyholders with lower-cost insurance by means of flexible pricing features. The second is funding reserves for benefit payments.

Flexible pricing features are contained in most life insurance policies written today. They provide policyholders with less expensive protection when the company enjoys favorable investment results or a favorable claims experience. A wide variety of flexible pricing features may be used. They include variable death benefits, premium adjustments, excess interest in one form or another, and traditional policyholder dividends. Regardless of form, however, all of these flexible pricing features serve the same economic and competitive functions. They allow companies to reduce the net cost of insurance protection to their policyholders.

Despite the economic role of these features as a cost of doing business, the complexity of the 1959 act has led to controversy over whether a full deduction is allowable for any of them. There is no question that deductions for some of them are limited under the act.

This is wrong, and a tax based on economic income would correct it. A tax on economic income would require a full deduction for the cost of producing revenues, including the cost of providing any of these flexible features. Moreover, the cost of providing any of these flexible features would be treated equally for tax purposes, thereby assuring tax parity between similar products.

A tax based on economic income also provides answers to the problems posed by reserves. A life insurance company is required by State law to maintain certain reserves. The most important of these reserves represents the estimated present value of the company's net liabilities to pay benefits to its policyholders.

An income tax requires the companies to reflect economic income on an annual basis. For insurance companies, this can only be achieved by allowing appropriate deductions for companies' liabilities to their policyholders, that is, for their reserves.

When a company receives a life insurance premium, it assumes a liability to pay benefits years or even decades in the future. Unless the income and the cost of the benefits are matched by being accounted for in the same taxable year, the company's reported income will be badly distorted. By taking reserves into account throughout the policy's duration, receipts and expenses are properly matched and income is correctly reflected.

The company's reserves for State regulatory purposes represent its own best estimates of its net liability to pay future benefits. The 1959 act, however, allows some reserves far in excess of those best estimates. As a result, some companies enjoy deductions in excess of their economic costs of operations.

This is wrong, and a tax based on economic income can correct it.

To reduce the possibility of windfalls or unjust tax increases, reasonable constraints and transitional rules would be needed. But under the permanent law, companies should deduct no more and no less than their actual cost of operations. Deductions should be related to true costs and liabilities, and there should be an end to the special deductions and deferrals provided by current law that do not reflect economic costs.

That is right, and a tax based on economic income is the way to do it.

Thank you.

Mr. **Van Fossan**. Thank you, Walter.

Next, Mr. Chairman, I should like to call on Coleman Bloomfield, chairman of the board and president of the Minnesota Mutual Life Insurance Co.

STATEMENT OF COLEMAN BLOOMFIELD, CHAIRMAN OF THE BOARD AND PRESIDENT, THE MINNESOTA MUTUAL LIFE INSURANCE CO., ST. PAUL, MINN., ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **Bloomfield**. Thank you, Mr. Chairman. I am grateful for this opportunity to testify before this subcommittee.

I will address the question of a differential in tax as between mutual and stock companies, and will recommend that there be no differential because of three simple basic facts:

Fact No. 1: The products are the same. Consumers perceive no difference in products offered by mutuals relative to stocks. They do not perceive any differences because the differences are not fundamental, they are purely technical. Many years ago there were fundamental differences in product design. Today there are none.

Fact No. 2: The David and Goliath image of stocks and mutuals is a myth. While 25 years ago the mutual companies did enjoy a predominant share of the market for life insurance, that condition no longer exists. In 1983, the mutual companies' share of the market is approximately 50 percent, with the mutuals having slightly more than half of assets and slightly less than half of insurance in force. The trend continues to move toward the stocks and away from the mutuals, and so, while some proponents of a tax penalty for mutuals strive to convey a David and Goliath image, that imagery is invalid.

Fact No. 3: There is no precedent for any distinction. There is no precedent for a differential in tax. Federal income tax law does not generally impose penalty taxes on mutual organizations or grant special relief for stock companies. Even within the life insurance industry, there was no differential prior to 1959. The merits of such a distinction in the 1959 tax law were then questionable. At this time, an extension of tax preferences for stocks or a tax penalty for mutuals would be totally inappropriate.

Despite these facts, Mr. Chairman, there are some, including certain stock companies, that believe there should be a differential. Their theory is that mutual policyholders are equity owners, like shareholders, so that some portion of policyholder dividends should be nondeductible by the company and taxed to the policyholders. This treatment is asserted to be necessary to achieve equal taxation of the equity returns of stock and mutual companies.

Mr. Chairman, this theory is simply wrong, because in fact it is not necessary to deny policyholder dividend deductions if the goal is equivalent taxation of stock and mutual companies. Our proposed approach of basing the life company tax on economic income, with full dividend deductibility and an appropriate limit on reserves, would raise reasonable revenues from mutual as well as from stock companies, and we are prepared to work with this subcommittee to insure this result. A tax based on economic income is competitively neutral by definition.

Furthermore, Mr. Chairman, I think I can show with a slightly different approach that mutual and stock company taxes are essentially equivalent under our economic income approach.

First consider the company tax. Any purported mutual policyholder equity must be acquired by the payment of premiums which are taxed to the company. In comparison, the equity or capital contributions made by shareholders are not subject to corporate tax. This contrasting treatment of contributed capital results in equivalent treatment of stock and mutual company earnings or equity returns, even with full dividend deductibility.

Mr. Chairman, I know this concept may be confusing, so let me try to explain with a simple example, using a 46-percent corporate tax rate. If shareholders contributed $100 to a corporation that earns a 10-percent pretax return or earns $10, the corporate tax is $4.60 and the after tax return is $5.40.

On the other hand, if mutual company policyholders contribute $100 as the purported equity portion of their premiums, the corporate tax reduces the amount the company has to use in the business to $54. This means that the company's after tax return, assuming the distribution of all earnings as deductible dividends, is also $5.40, just like the stock company. This is why I say that our proposal essentially treats stock and mutual companies alike.

Now let us focus on the policyholder tax. Briefly, our position is that even if policyholder dividends were partly treated as shareholder dividends, they would generate an insignificant amount of tax. This is because most mutual policyholders are low- and middle-income taxpayers whose unused shareholder dividend exclusions would result in virtual tax exemption.

In summary, Mr. Chairman, there is no tax law principle that justifies a significant differential at either the company or the policyholder level. The tax on stock and mutual companies should be uniform and provide no differential. Thank you, Mr. Chairman.

Mr. **Van Fossan**. Thank you, Coleman.

Next, Mr. Chairman, I would like to call on Frank Purvis, Jr., to serve as our cleanup hitter today, chairman and chief executive officer of the Pan-American Life Insurance Co.

STATEMENT OF G. FRANK PURVIS, JR., CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, PAN-AMERICAN LIFE INSURANCE CO., NEW ORLEANS, LA., ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **Purvis**. Thank you.

Mr. Chairman and members of the subcommittee, I appreciate very much the opportunity to testify before you here today. I am, as Bob has said, G. Frank Purvis, Jr., chairman of the board and chief executive officer of the Pan-American Life Insurance Co., which is headquartered in New Orleans, La. Today, I will briefly discuss some of the important reasons to retain the current rules regarding the taxation of some 147 million Americans who own life insurance.

The current rules for taxing policyholders date back to 1913. Under these rules, death benefits paid under a life insurance policy are not taxed. Also, policyholders are not taxed on increases in the values of their policies while they own them. However, if a life insurance policy is surrendered, the excess of its cash value over the premiums paid for it is taxed at ordinary rates.

Not only do these rules tax a life insurance policy like any other appreciating asset, but they further important social purposes. Life insurance provides economic protection against premature death, thereby assuring the financial security of the insured's dependents. Over 85 percent of American families own life insurance today.

Despite increases in the amount of life insurance that families own, protection for all insured families is currently equal to only about 23 months of total disposable personal income per family. If life insurance death benefits were taxed, the amounts provided for the financial well-being of the insured's dependents would be substantially reduced.

Permanent life insurance with cash values developed as a practical means of providing life insurance protection at older ages. The cost to the policyholder of insurance protection greatly increases as the insured grows older. On the other hand, permanent life insurance makes possible the payment of level premiums throughout the premium-paying period. Any tax on cash value would impair the ability to maintain necessary insurance protection at higher ages.

The vast majority of permanent life insurance policies are owned by low- and middle-income taxpayers. In 1982, 82 percent of all ordinary life insurance policies were purchased by individuals with incomes below $25,000. For these individuals, privately owned life insurance is the best way to protect and to provide for the financial well-being of their families. Moreover, these individuals would be the least able to afford the higher cost of insurance caused by increased taxes.

I also stress that the current rules for taxing policyholders are consistent with general Federal income tax principles applicable to analogous appreciating assets. Appreciation on other assets is not taxed until realized. Moreover, although subject to estate taxation, unrealized appreciation of other assets is not subject to income tax at death. Consistent with these principles, increases in the cash values of a life insurance policy should not be taxed until the policy is surrendered, and any tax on the unrealized appreciation should not be taxed at death.

Finally, the current rules for taxing life insurance are consistent with the tax treatment of other major vehicles which, like life insurance, provide long term savings for retirement and financial security needs of middle-income Americans. These include qualified retirement arrangements, owner-occupied housing and social security.

My testimony today has been in support of retaining the current rules for taxing individual owners of policies whose primary purpose is to provide protection. We recognize that there are some products in the marketplace that are labeled life insurance that are purchased primarily as investments. Unlike life insurance policies, which are bought to provide protection, these products are designed for investment, and they may compete with other taxable forms of investment.

We believe that such products should not be treated as life insurance for tax purposes. To achieve this, life insurance should be defined so that the law will assure that policies which are primarily investment oriented do not qualify for the tax rules properly applicable only to life insurance policies.

Thank you very much.

Mr. **Van Fossan**. Thank you, Frank.

Mr. Chairman, that concludes our formal presentation and we stand ready to respond to any questions you or the committee might have.

[The prepared statement of Messrs. Van Fossan, Creedon, Martin, Gerken, Bloomfield, and Purvis follow:]

Statement of Messrs. Van Fossan, Creedon, Martin, Gerken, Bloomfield, and Purvis, on Behalf of the Mutual Company Executive Committee

I. Opening Statement—Mr. Van Fossan.

A. Description of mutual companies, their pro-consumer orientation, and their roles in the industry.

B. Summary of II–VI.

II. The 1959 Act must be replaced—Mr. Creedon

A. The 1959 Act is irrational.

1. Some companies are taxed on their economic income; others are taxed on more than their economic income; still others are taxed on less than their economic income.

2. Companies are allowed to overstate reserves and understate income.

3. Some companies are allowed deductions for expenses and liabilities they do not incur; others are denied deductions for payments to customers actually made.

4. There are wide differences of tax levels on identical products issued by different companies.

5. Abusive insurance policies are encouraged.

6. The marketplace is distorted and consumers are harmed.

B. The 1959 Act is too complex.

1. Courts and commentators are in agreement that the three-phase system of present law is nearly incomprehensible.

2. Treasury and GAO likewise have concluded that return to a simpler law is desirable.

C. The 1959 Act is unfair.

1. The law was designed to impose predetermined levels of tax on stock and mutual companies irrespective of their income.

2. Statistics show that industry taxes have increased disproportionately.

3. Under recent conditions, mutual companies pay a tax that is totally disproportionate to their income in relation to the income of stock companies.

D. Only last year Congress, the Treasury and the entire industry agreed that the 1959 Act is unworkable; it is unthinkable that Congress would permit a return to that law by failing to act this year.

III. Stopgap was an improvement, but it, too, has serious weaknesses—Mr. Martin.

A. Wide disparity in treatment of participating products is permitted.

B. Does not reliably relate revenues to economic income.

IV. A new corporate tax based on economic income that is more like the tax applicable to other corporations must be established—Mr. Gerken.

V. There is no justification for a mutual-stock differential—Mr. Bloomfield.

VI. At the policyholder level, current law should be retained for traditional life insurance products, but investments with thin veneers of insurance should not be treated as life insurance—Mr. Purvis.

MUTUAL COMPANY STATEMENT
ON LIFE INSURANCE COMPANY TAX LEGISLATION

Testimony of

Robert V. Van Fossan, Chairman and Chief Executive Officer
The Mutual Benefit Life Insurance Company

John J. Creedon, President and Chief Executive Officer
The Metropolitan Life Insurance Company

James R. Martin, Chairman
Massachusetts Mutual Life Insurance Company

Walter Gerken, Chairman and Chief Executive Officer
Pacific Mutual Life Insurance Company

Coleman Bloomfield, Chairman of the Board and President
The Minnesota Mutual Life Insurance Company

G. Frank Purvis, Jr., Chairman and Chief Executive Officer
Pan-American Life Insurance Company

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 10, 1983

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Appendix A - Mutual Life Insurance Companies Supporting This Statement

Appendix B - Responses to Specific Questions of Subcommittee on Select Revenue Measures

Appendix C - Inequitable Tax Burdens Under the 1959 Act

I. Introduction

A. Who We Are

This statement summarizes the views of mutual life insurance companies on a permanent revision of the federal income tax laws applicable to life insurance companies. The statement was prepared by a 14 company Mutual Company Executive Committee. The Committee was formed to provide an information clearinghouse and to formulate positions on life insurance company tax legislation on behalf of all mutual life insurance companies. Appendix A lists the companies on the Committee and other companies that have formally approved this statement.

Mutual life insurance companies operate under cooperative principles. A cooperative is a form of organization in which the members join together to achieve a common economic purpose. Mutual life insurance companies have as their primary purpose the provision of insurance at cost to their member policyholders. Unlike stock companies, mutual companies have no shareholders. Mutual companies, which include some of the largest and oldest U.S. life insurance companies, play a major role in providing life insurance protection to millions of American policyholders. In 1959, when the income tax laws applicable to life insurance companies were last examined, mutual companies were dominant in the marketplace with more than 75 percent of total industry assets and 63 percent of insurance in force. Today, mutual companies have less than a 55 percent asset share and less than a 50 percent share of insurance in force. It is expected that in 1984 the mutual share of these items will be 54 percent and 46 percent, respectively.

B. What We Have to Say

Mutual companies very much appreciate the opportunity afforded by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means to present our views on permanent life insurance tax legislation. We agree with what we perceive to be a consensus among tax policymakers that the current structure for taxing life insurance companies is overly complex, inequitable, and badly in need of a fundamental overhaul. We are delighted that the members of this Subcommittee are taking the lead in this process. We offer our fullest cooperation to the Subcommittee in its attempt to fashion a simpler, more rational law -- one that is fair to the government, to all segments of the life insurance industry, and to life insurance policyholders who ultimately must bear the burden of our taxes.

We have organized the remainder of our statement into three parts. First, we summarize mutual company views on the basic approach and criteria for any valid income tax law. Second, we review the reasons why the former law, the Life Insurance Company Tax Act of 1959 (the "1959 Act"), is flawed and must be replaced. Third, we present mutual company views on twelve major issues involved in the taxation of life insurance companies. Additionally, in order to be as helpful as possible to the Subcommitte, we have attached as Appendix B our specific responses to each of the twenty-four questions posed in the Subcommittee's April 8, 1983 press release. Where appropriate, we have cross-referenced our answers to specific discussions of these issues in the text of our statement.

Of necessity, this statement can reflect only a summary of our views. We are fully cognizant that this is an extremely complex subject and would welcome the opportunity to explore in more detail any of the issues discussed here.

II. Basic Approach and Criteria For a Permanent Tax Law -- the Need to Tax Economic Income

Fundamentally, mutual companies believe that any permanent tax structure should be designed to measure a life insurance company's economic income. In other words, life insurance companies should be taxed on the total of their investment and underwriting income. All other corporations are taxed on their economic income, and there is no justification for subjecting life insurance companies to a different rule. Any other approach invites further decades of controversy and uncertainty.

As a corollary to our belief in a tax based on economic income, we also agree with views expressed by the Subcommittee Chairman, the Treasury Department, and the Chairman of the Senate Finance Committee that a workable permanent tax law must proceed from rational principles and cannot be fashioned by an arbitrary split of preselected tax revenues among industry segments.[*/] The latter approach would lead to a patchwork law that will inevitably unravel with changes in the industry and in the economy. Not only would it be impractical, it would also be inequitable to select a revenue level and work backward to construct a tax law. The life insurance tax law should be fashioned by a rational analysis proceeding from general tax principles; it should not be revenue-driven.

A permanent tax law measured by economic income should also meet several specific criteria, including principally the following:

- The law should allow a full deduction for all business costs, including all amounts paid or credited to customers. Conversely, artificial deductions should not be created where they do not reflect actual payments or liabilities.

[*/] See Remarks by John E. Chapoton, Assistant Secretary for Tax Policy, Annual Meeting of the Association for Advanced Underwriting (March 1, 1983); Letter from Robert Dole, Chairman, Senate Finance Committee to Richard S. Schweiker, President, American Council of Life Insurance (February 28, 1983).

- In recognition of commitments to policyholders, the law should allow a deduction for reserves set aside to satisfy such policyholder liabilities as long as those reserves are reasonably computed.

- The law should not distort competition. As expressed in a recent public statement by Assistant Treasury Secretary Chapoton: "In a fair tax system, competing products sold by mutual and stock life insurance companies should be subjected to comparable tax rates on comparable income."

- The law should be as consistent as possible with the taxation of financial institutions that offer both long- and short-term investment opportunities, while continuing to recognize the distinctive role of life insurance as a long-term means of providing family financial security in the event of death or retirement.

The basic approach and criteria we suggest do not reflect new or novel concepts but follow the very approach favored by the Treasury Department in 1959. Stating Treasury's position on the taxation of life insurance companies, Treasury Secretary Anderson wrote to Ways and Means Committee Chairman Wilbur Mills:

> The method of taxation to which it is suggested the committee give first consideration would provide a long-range basis of taxation for life insurance companies bringing their taxable income concept into closer conformity with that of other corporate business. Such a concept should be designed to reflect, to the fullest extent practicable, the full net earnings of life insurance companies. It should at the same time provide comprehensive deductions for all expenses, interest, and reserve requirements, and all amounts paid or made available to policyholders.

Unfortunately, this sound advice was not heeded in the process leading to enactment of the 1959 Act.

III. The 1959 Act Is Flawed and Must Be Replaced

The current legislative activity reflects increasingly widespread recognition that something is very wrong with the basic structure of current life insurance company tax law. Mutual companies agree with this assessment. Further, we think it is helpful in designing a new law to understand why the current law is flawed.

A. Failure To Tax Economic Income

The essential defect in the 1959 Act structure is that it is not designed to tax a company's real economic income. Rather, when a company's economic income differs from its investment income, the company's tax base will often be equal to, or skewed toward, that latter figure. Thus, through a complicated phase system, the 1959 Act taxes various companies on entirely different bases. For many companies, including most mutuals, the tax base is investment income (determined under an arbitrary allocation formula) without regard to a company's actual overall gain or loss. For some other companies, the tax base is true economic income (or economic income _plus_ the cost of providing policyholders with policyholder dividends or other flexible pricing features). For still others, the tax base is economic income less special deductions and deferrals that have no basis in either economic or tax policy.

The extent to which the 1959 Act ignores economic income is dramatically illustrated by an example attached as Appendix C. The example depicts three hypothetical life insurance companies that all have the same economic income and the same income for regulatory purposes (_i.e._, annual statement income). And yet they have strikingly different tax bases and inequitably disparate effective tax rates.

Because it fails to tax economic income, the 1959 Act also fails to satisfy other criteria of a sound tax law. The Act contains several artificial deferrals and deductions that are available only to some companies and reflect neither actual expenses nor actual liabilities. By allowing companies differing deductions for amounts credited to policyholders on equivalent products, the Act has distorted competition in the sales of life insurance products. The Act is also overly complex and its rules are not consistent with the principles applicable to all other taxpayers.

B. Malfunctions in the Face of Economic Change

In addition to failing to tax economic income, the 1959 Act's emphasis on investment income has proved unable to cope with changing economic conditions such as inflation and high interest rates. In 1959, the inflation rate was less than 1 percent, and interest rates were at a relatively stable 3 to 4 percent level. Under the 1959 Act's investment income formula, as investment income rises, a higher and higher percentage of investment income becomes subject to tax regardless of whether these amounts are used to provide benefits to policyholders. The inability of the law to take into account changing economic conditions is dramatic. Statistics compiled by the American Council of Life Insurance (ACLI) show that while life insurance company gain from operations increased only fourfold from 1960 to 1978, the company tax burden increased by a factor of six. During the same period, the after-tax income of corporations generally increased four and one-half times while the taxes of such corporations grew only three times. As a result, the life insurance company share of total corporate taxes increased by 75 percent (from 2.4 to 4.2 percent).

The Act also severely limits the deduction of amounts actually credited by life insurance companies to their policyholders. Mutual companies are disproportionately hard hit. In 1959, mutual companies were able to deduct 90 percent of their policyholder dividends. Today, under the temporary TEFRA provisions, mutual companies may deduct only 77.5 percent of policyholder dividends, and in the absence of the TEFRA provisions, only about 50 to 55 percent would be deductible.

C. Reliance on the Discredited and Unworkable Concept of "Free Investment Income"

The complicated phase system of the 1959 Act is sometimes defended on the basis that it taxes companies under a "free investment income" concept. The free investment income concept, in very general terms, is a theory that life insurance companies should be taxed on any investment income that is not necessary to satisfy a limited class of obligations to policyholders. The free investment income concept was reflected in the various tax laws applicable to life insurance companies prior to 1959, all of which proved to be unworkable. The 1959 Act was in part an effort to move away from a reliance on the free investment income concept toward a total income approach to the taxation of life insurance companies.

Indeed, it is the failure of the 1959 Act to reject the free investment income concept totally that is the very root of our current problem. Continued reliance on the free investment income concept, in the guise of the phase system, has led to ever-increasing tax burdens and to tax planning opportunities such as modco and excess interest. Other problems spawned by the phase system of the 1959 Act include various tax audit issues and multiple competitive inequities. The very existence of a phase system inevitably spawns tax avoidance techniques designed to shift income from one phase to another. Only under a phase system can tax liability be reduced by moving a dollar of income from the left pocket to the right.

Why should the free investment income concept be rejected? There are several reasons.

1. Opportunity for Manipulation

A free investment income tax base is not objective. Under all formulations of the concept yet devised, an insurance company can, within limits, control how much of its investment income is considered to be "free." These problems can in part be dealt with through mechanisms, such as the current "Menge" formula, that are designed approximately to measure the company's "free" income and also to reduce the company's ability to manipulate the outcome. Such approximations, however, cannot accurately reflect the amount of interest required to satisfy policyholder obligations on a uniform basis. As the 1959 Act has sadly proved, approximations also become unworkable when interest rates are volatile.

2. Unjustifiable Discrimination Against Flexible Policy Benefits

Probably the major conceptual defect with the free investment income notion, however, is the implicit assumption that it makes a difference whether an insurance company's investment income is used to provide traditional fixed benefits or whether it is used to provide flexible benefits. Such flexible benefits include policyholder dividends, price reductions, variable benefits, and excess interest. Investment income used to provide the latter benefits is no more "free" than investment income used to provide the former. Whether a benefit falls in one category or the other is a function primarily of factors such as the expected stability of interest rates, state regulation, competing products, and the conservatism of management in pricing policies. Whether a benefit is flexible or fixed is totally irrelevant for determining a company's economic income.

3. A Penalty When Interest Rates Rise

Finally, the free investment income approach penalizes companies as their earnings rates increase. This is because the marginal rate of tax on investment income increases as earnings rates rise regardless of whether these amounts are used to provide additional policyholder benefits. To put it another way, under the "free investment income" concept of the 1959 Act, there is a zero deduction at the margin. Thus, life insurance companies are unfairly handicapped in their efforts to compete as purchasers of goods and services since they cannot deduct all of their expenses.

IV. Mutual Company Views on Specific Issues

The mutual company view on specific issues is as follows:

A. Reserves

1. The Need to Deduct an Estimate of Future Liabilities

In general, the basic approach we favor would tax life insurance companies in the same manner as other corporations. There is, however, one respect in which life insurance companies are unique, and for which appropriate provisions must be made. It is the nature of life insurance companies to make long-term commitments to their policyholders. In the typical case, the company will have a decades-long revenue stream that must be used to satisfy an associated liability to pay future benefits. A gross distortion of income would result from a failure to recognize both the income and the associated liability in the same taxable year. Thus, to reflect income clearly, life insurance companies must be allowed an adequate deduction for reserves, which reflect an estimate of the present value of their net liabilities to pay future claims.

The income tax laws historically have recognized reserves established under state law financial accounting. We believe these reserves accurately reflect a company's liabilities, and thus state law reserves should remain the standard for federal income tax purposes.

We also recognize that there are some legitimate concerns about possible overstatement of reserves in certain cases. Any such concerns, however, should be addressed with narrowly targeted measures rather than abandonment of state law standards. For instance, we favor elimination of the section 818(c)(2) approximate revaluation method. In many situations for many products, the approximation in current law results in a reserve deduction clearly in excess of that sought to be approximated. Also, today's computer technology has eliminated the practical need for approximations. Additional limitations on reserves might also be considered. For example, companies might be limited to reserves as reflected on their annual statements or as computed according to some generally recognized reserving method, such as the Commissioner's Reserve Valuation Method (CRVM) for individual policies.

2. Transitional Issues

If reserve limitations along these lines are adopted, companies should be permitted to compute reserves for tax purposes on the new basis as of the beginning of the taxable year containing the transition point. Serious distortions will arise unless reserves are calculated on a consistent basis in the year of transition. Also, given the diverse impact of reserves under prior law and the fundamental changes proposed, a failure to apply the new basis to all reserves will result in either serious inequities or onerous allocation difficulties.

B. Flexible Pricing Features -- Policyholder Dividends and Similar Amounts

In order to determine the treatment of policyholder dividends and similar amounts under corporate tax principles, it is important to understand what policy dividends are and what they are not. Policyholder dividends and other similar amounts are the means through which companies adjust the price of their insurance policies. Policyholder dividends are not similar in nature to stockholder dividends, and in this sense the use of the term "dividends" is misleading. A more accurate and inclusive term would be "flexible pricing features."

Flexible pricing features may be used to provide increased benefits for the old price or a reduced price for the old benefits. In the former case, the costs to the company of the new benefits increase the cost of doing business. In the latter case, the price reduction is merely a rebate or refund of amounts which, in the judgment of the company, are not needed to satisfy the company's contractual obligations to policyholders.

These flexible pricing features have traditionally been used by mutual companies and some stock companies to achieve the objective of providing insurance at cost to policyholders. More recently, stock companies have introduced additional pricing mechanisms such as "excess interest" and indeterminate premium policies under which premiums may be adjusted to reflect favorable experience.

A tax on economic income should recognize that the cost of implementing flexible pricing features is a cost of doing business, and consequently it reduces a company's economic income. Other corporations deduct or exclude price rebates from income, and there is no reason for treating life insurance companies differently. Imagine denying General Motors a deduction for rebates on the sales of new cars!

As indicated, in considering the treatment of policyholder dividends, it must be kept in mind that the issue applies far more broadly than to traditional policyholder dividends under participating policies. Simple equity requires that all flexible pricing features be treated alike. Under the permanent tax law, therefore, whatever treatment is accorded policyholder dividends must apply with equal force to similar items such as excess interest, price reductions under indeterminate premium policies, increases in death benefits not fixed at issue, and amounts over minimum levels which vary according to an underlying investment fund. Such flexible amounts should be treated in the same manner as policyholder dividends regardless of whether they are discretionary or fixed by formula and regardless of whether they are retrospective or prospective. Such treatment is necessary to achieve the goal of neutrality between different forms of contracts which are actually similar in economic substance.

C. Product Equity

The 1959 Act taxes in different manner various life insurance companies selling the same or similar products. Some companies get a full deduction for amounts credited to policyholders; other companies' deductions are severely limited. These variations in tax treatment distort competition by giving companies advantages based solely on differences in tax treatment. These product-related tax inequities should be eliminated under a permanent law so that companies can compete on the basis of their products and not on the basis of an inequitable and illogical tax law.

D. Pension Business

Congress has consistently endorsed the concept of parity between insured and noninsured tax-qualified employee pension plans. In some circumstances, however, the 1959 Act fails to provide parity because it fails to allow a full deduction or a full exclusion for all amounts credited by life insurance companies to pension plan business. This defect should be remedied. Of course, we also recognize that a life insurance company should not be allowed to deduct or exclude amounts in excess of those attributable to, or actually credited to, pension plan business. Once the basic structure for the taxation of life insurance companies is developed, a system designed to achieve parity between insured and noninsured pension plans can be formulated.

E. Group Insurance

Life insurance companies are currently subject to tax on investment income that is used or set aside to provide benefits under employee welfare plans. These plans include both group life insurance policies and accident and health policies purchased by employers to provide health benefits for their employees. This tax on insured employee welfare plans should be eliminated for many of the same reasons that make a tax on insured pension plans inappropriate.

1. Alternate funding media for employee welfare plans are not subject to federal income taxes on investment income allocated to benefits. For example, if an employer reimburses employees for medical claims on a pay-as-you-go basis, the employer receives a full deduction from income. Alternatively,

an employer may subscribe to a Blue Cross and Blue Shield plan or a health maintenance organization which insures the payment of medical benefits. Such organizations are exempt from federal income tax. Health insurance benefits may also be provided by casualty insurance companies. While these companies are taxable entities, they are allowed to deduct investment earnings set aside to satisfy policyholder liabilities for medical benefits. Finally, employee health benefits and employee death benefits can be provided through tax-exempt trusts.

2. The availability of nontaxable alternatives places life insurance companies at a serious competitive disadvantage, which is reflected in the trend away from the use of insured arrangements.

3. The costs of employee welfare plans using insurance are substantially greater as a result of the federal income taxes paid by life insurance companies.

4. Small employers are most likely to suffer from this tax discrimination because of their need to rely on the guarantees provided through life insurance company arrangements which are not available through noninsured arrangements.

For these reasons, we believe that the investment income of life insurance companies which is attributable to employee welare plans should not be taxed. We also note that correction of this inequitable tax treatment should not involve a significant loss of revenue. Currently, the taxes imposed on life insurance companies are reflected in the premiums for health and group life insurance, and employers can deduct these premiums.

F. Special Deferrals and Deductions

The 1959 Act permits certain companies to deduct and defer certain amounts relating to nonparticipating contracts and amounts relating to accident and health insurance and group life insurance contracts ("special deductions"). The Act also permits certain companies to defer indefinitely the taxation of one-half of the excess of their gain from operations (*i.e.*, economic income less the special deductions) over their taxable investment income (the "phase II deferral").

Special deferrals or deductions should not be allowed unless the items involved relate to real economic costs or liabilities. The special deductions and phase II deferral do not meet this standard. They in part reflect an inevitably ill-fated decision in 1959 to construct a tax law based upon an arbitrary split of a revenue target between industry segments.

There is no tax-policy for or economic substance to the occasionally encountered rationalization for these deferrals and deductions -- that they are needed to compensate for risks inherent in the life insurance business. Companies maintain reserves that state regulators and the tax-paying companies themselves believe to be adequate to provide for contingencies; full deductions are allowed for these reserves; and these deductions have proved adequate. A more appropriate mechanism to recognize the uncertainty in annually measuring income from life insurance would be to expand the loss carryback provisions for all life insurance companies.

Further, although current law contains mechanisms for eventually including deferred amounts in taxable income, virtually no tax has been paid on these amounts in the more than 20 years since the enactment of the 1959 Act. It is estimated that more than $9 billion has been deferred with no foreseeable likelihood under existing law of any substantial amount of tax ever being paid.

In any event, if it is nevertheless determined that special deductions should continue to be allowed, they should be allowed for all companies issuing these policies. Under the 1959 Act phase system, only companies whose gain from operations exceed taxable investment income ("phase II positive companies") benefit from these special deductions. The deductions, if allowed, should be available to all life insurance companies on an equal basis.

G. Ownership Differential

Some stock companies assert that the tax law should be based on the premise that mutual company policyholders are like stock company shareholders and that policyholder dividends are returns on equity analogous to stock dividends. These premises are wrong. The federal income tax law generally does not treat participants in mutual enterprises as shareholders, and there is no reason to depart from this rule in the case of mutual life insurance company policyholders. The nature of mutual company policyholders' interests is substantially different from that of shareholders. For instance, policyholders' interests are not marketable or otherwise transferable to realize capital appreciation.

Whatever characterization is applied to policyholders' interests, it should be applied consistently to the policyholders of both stocks and mutuals. The stock claim, in essence, is that mutual policyholders' rights under their policies make them de facto shareholders. But many stock companies also issue policies with flexible pricing features. These policies are in substance the economic equivalent of policies issued by mutual companies. If mutual policyholders are to be considered de facto shareholders, then consistency requires equivalent treatment for the policyholders of equivalent policies issued by stock companies.

Even if an ownership differential theory that treats policyholders as shareholders is accepted, the appropriate amount of any differential is zero or very small.

Unlike stockholders' equity contributions, which are excluded from company income, any equity that mutual company policyholders are purported to have contributed is included in the company's taxable premium income. Even if subsequent policyholder dividends are fully deducted, the prior inclusion of premiums is economically equivalent to the full corporate taxation of any purported mutual company equity returns.

Moreover, even if policyholder dividends were treated as shareholder dividends, they would generate little tax liability in the hands of policyholders. The combination of mutual company policyholders' middle-income tax brackets and the tax law's exclusion for shareholder dividends would result in little or no individual tax. The facts simply do not support a significant ownership differential at either the company or policyholder level.

Finally, any differential that may be imposed on mutual companies should not be extended to their stock subsidiaries. These subsidiaries are stock companies in substance and in form and should be taxed as such. Mutual companies expect a return on their investments in subsidiaries just as any other stockholder does. In fact, state insurance regulations, competition, and principles of mutuality all operate to preclude a mutual company from placing surplus in a subsidiary with no expectation of a return.

Some stock companies allege that stock subsidiaries of mutual companies should be treated like mutual companies because mutual companies may gradually issue new lines of participating business through subsidiaries which, after the repayment of the "seed" cost, will be operated as mutual organizations, that is, providing insurance at cost. This is not true, and even if it were true it is irrelevant. If a differential is to be imposed on the basis of whether business is participating or nonparticipating instead of whether the company is a stock company or a mutual company, substantially the same differential should be imposed on all participating business of stock companies as that imposed on the participating business of mutual companies. Moreover, the definition of participating must be a practical one that would include price adjustment features that are economically equivalent to policyholder dividends.

H. Policyholder Taxation

Questions have been raised about whether policyholders should be taxed on the growth of cash values in life insurance policies, or whether policyholders should be denied an interest deduction on life policy loans. These results would be fundamentally at odds with sound tax policy and with sound public policy.

A life insurance policy is like an appreciating asset, and current law recognizes this fact. Taxing the inside build-up also would be contrary to the principle of deferring tax on appreciating assets until the appreciation is realized. Similarly, it would be wrong to deny a deduction for interest on policy loans since interest on loans secured by appreciating property is generally deductible.

Without the buildup of value in a life insurance policy, it would be impossible for companies to enable policyholders to maintain their insurance in force with the payment of only level premiums. If premiums were required to rise sharply with age, many policyholders might be unable to maintain sufficient insurance in force to protect their families. The tax law has always been designed to encourage the purchase of insurance so that dependents are provided for in the event of the wage earner's death. This important social policy should be continued.

In addition, the tax treatment of life insurance is consistent with developing ideas about the proper taxation of investments. Consistent with these ideas, which are related to a consumption tax theory, the primary investments, other than life insurance, that are made by Americans to provide long-term security are all effectively tax deferred. These include qualified retirement arrangements and owner-occupied housing. Life insurance performs comparable functions and competes with these other investments. Accordingly, it should be treated in a similar manner.

Mutual companies recognize, however, that there are products in the marketplace that are primarily short-term investment vehicles masquerading as life insurance. These products should not qualify for the tax treatment afforded to life insurance or the long-term investments with which life insurance competes. In this regard, we believe that life insurance should be defined so that this tax treatment is available only to policies whose predominant purpose is the provision of life insurance protection. In general terms, such a definition would include contracts which provide for death benefits and whose cash values cannot exceed the net single premium for the benefits provided under the policy. This definition will assure that the only amounts that can be accumulated under the contract are those amounts actually needed to provide life insurance protection.

I. Taxation of Investments

Some questions have been raised concerning the impact of the income tax law on life insurance company investments. This is generally recognized to be an important issue because of the vital role played by life insurance companies in providing capital to the U.S. economy. In 1980, for example, life insurance companies provided 39 percent of all funds raised by U.S. business through corporate bonds and commercial and industrial mortgages.

It should be noted initially that investments made by life insurance companies are in large part dictated by the nature of our business and by state law investment restrictions. Life insurance companies are primarily in the business of making long-term commitments to their policyholders. Thus, historically, life insurance companies have been major investors in long-term, fixed income securities which complement their contractual obligations to policyholders.

The income tax laws, however, can and do influence investment decisions. The clearest example of this is the proration concept of the 1959 Act. Because reserve deductions are equal to the present, not the future, value of net future benefits, some portion of the company's investment yield must be excluded from income each year in order to allow the reserve to grow to the full value of the benefit that will actually be paid. Proration is a computational procedure that attempts to avoid disproportionate concentration of tax-favored receipts (such as exempt interest and intercorporate dividends) in either the excluded or included portions of investment yield *i.e.*, the policyholder share or the company share, respectively. Thus, if exempt interest comprises ten percent of investment yield, it is deemed, as a result of proration, to comprise ten percent of both the excluded and the included portions.

In practice, these rules operate in a way that imposes an additional tax burden on intercorporate dividends and exempt interest. For instance, receipt of additional exempt interest results in an increased tax liability notwithstanding the nominally "exempt" character of the receipt. Although the constitutionality of this formula has been upheld, it is questionable tax policy to treat life insurance companies less favorably with respect to these types of investments than other corporate taxpayers are treated. The proration rules have been a substantial disincentive to life insurance companies to invest in the obligations of state and municipal governments, and in common stocks.

In any event, even if the proration concept were nevertheless incorporated in a permanent tax law, it should not apply to dividends received by mutual or stock life insurance companies from their subsidiaries. All other corporations are allowed a 100 percent dividends received deduction for dividends received from their subsidiaries. This dividends received deduction is provided to avoid double corporate taxation of corporate earnings, a policy which is equally applicable to the subsidiaries of life insurance companies. Furthermore, some stock companies can and do avoid the proration of subsidiary dividends by creating holding company structures under which the dividends are paid to a company other than the life insurance company. The current rules are inequitable since mutual companies cannot form similar holding company structures.

J. Minimum Tax

Companies with substantial economic income may totally eliminate their tax under the current 1959 Act structure. We recognize and accept the principle that all corporations, including life insurance companies, should pay a minimum level of tax if their economic income is positive. We believe that this objective will be facilitated by a permanent tax structure that treats life insurance companies like other corporate taxpayers, which would include provisions such as the corporate minimum tax under section 56 and the special rules relating to corporate preference items of section 291. Additionally, after a permanent tax structure is developed, other provisions might be considered to assure that some minimum share of taxes is paid by companies with positive economic income.

K. Small Companies

We believe that some sort of tax incentive for small mutual and stock companies is justified to foster competition. Some additional incentive is justified because of the high initial costs of developing new business, the highly competitive nature of the industry, and a predominance of large companies in the industry, with increasing reliance on economies of scale.

Unlike the 1959 Act, however, the permanent tax law should limit the incentives to small companies only. To avoid abuses, the definition of a small company should consider as a unit an entire group of related companies. The incentive should also be carefully designed to assist small companies effectively. Finally, both small stock companies and small mutual companies should be permitted to benefit from any special incentive designed for small companies.

L. Consolidated Returns

There are two major areas of controversy that have arisen in recent years concerning the filing of consolidated returns by affiliated groups including life insurance companies. Both types of controversy grow out of the multiple-phase system of taxation, under which an affiliated group's tax liability might be increased if consolidation were to treat the group as a single corporation subject to a multiple-phase tax.

The first major area of controversy involves the filing of consolidated returns by groups including more than one life insurance company. It has generally been the industry's position that life insurance companies should be allowed to file consolidated returns like other companies on a bottom-line basis. The Treasury Department and the Internal Revenue Service, on the other hand, issued proposed regulations which would have applied a unique phase-by-phase method of consolidation in these situations. The stopgap law allows the bottom-line method for prior years and for the stopgap period.

A second major area of controversy involves the consolidation of affiliated groups that include both life insurance companies and nonlife insurance companies. There are special statutory rules, enacted in 1976, which allow consolidation on a limited basis of groups containing life insurance companies and nonlife companies. Similar to its position on the consolidation of life insurance companies, the industry has maintained that the rules applicable to life/nonlife consolidation should be consistent with the rules applicable to the consolidation of companies generally. In the March 18, 1983 Federal Register, however, the Internal Revenue Service published regulations that treat life insurance companies and nonlife insurance companies as separate subgroups for purposes of consolidation.

Mutual companies believe that the controversies that have surrounded the filing of consolidated returns are simply another manifestation of the defects in the phase system of taxing life insurance companies. The phase system puts various companies in substantially different tax situations. It is this unique phase system of taxation that has created the issues that are so difficult to deal with in connection with the filing of consolidated returns. These issues would be resolved if, as recommended, the permanent tax structure applicable to life insurance companies taxed each company on the basis of its own economic income. If there were no phase system, it would make no difference whether consolidation was on the bottom-line basis or some different method analogous to phase-by-phase consolidation. Also, both the subgroup approach to life/nonlife consolidation and other special statutory restrictions would be unnecessary if the taxation of life insurance companies were made parallel to the taxation of corporations generally.

APPENDIX A

MUTUAL LIFE INSURANCE COMPANIES SUPPORTING THIS STATEMENT

Acacia Mutual Life Insurance Company

The American Home Life Insurance Company

Bankers Life Company

Berkshire Life Insurance Company

Boston Mutual Life Insurance Company

Connecticut Mutual Life Insurance Company

*Empire State Mutual Life Insurance Company

*Equitable Life Assurance Society of the United States

Farmers and Traders Life Insurance Company

The Fidelity Mutual Life Insurance Company

General American Life Insurance Company

Golden State Mutual Life Insurance Company

Grange Mutual Life Company

*Guarantee Mutual Life Company

*The Guardian Life Insurance Company

Home Life Insurance Company

The Home Mutual Life Insurance Company

Illinois Mutual Life and Casualty Company

Indianapolis Life Insurance Company

*John Hancock Mutual Life Insurance Company

Lincoln Mutual Life and Casualty Insurance Company

Lincoln Mutual Life Insurance Company

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*Member, Executive Committee

Lutheran Mutual Life Insurance Company

*Massachusetts Mutual Life Insurance Company

*Metropolitan Life Insurance Company

Ministers Life -- A Mutual Life Insurance Company

*Minnesota Mutual Life Insurance Company

*Mutual Benefit Life Insurance Company

The Mutual Life Insurance Company of New York

Mutual Service Life Insurance Company

Mutual Trust Life Insurance Company

National Guardian Life Insurance Company

National Life Insurance Company

New England Mutual Life Insurance Company

North Carolina Mutual Life Insurance Company

*Northwestern Mutual Life Insurance Company

Ohio National Life Insurance Company

Pacific Mutual Life Insurance Company

Pan-American Life Insurance Company

*Phoenix Mutual Life Insurance Company

Pioneer Mutual Life Insurance Company

Protected Home Mutual Life Insurance Company

*Provident Mutual Life Insurance Company

*The Prudential Insurance Company of America

Rushmore Mutual Life Insurance Company

*Security Benefit Life Insurance Company

The Security Mutual Life Insurance of Lincoln, Nebraska

Shenandoah Life Insurance Company

Standard Insurance Company

A-2A

The State Life Insurance Company

State Mutual Life Assurance Company of America

Union Mutual Life Insurance Company

Union Central Life Insurance Company

APPENDIX B

RESPONSE TO SPECIFIC QUESTIONS OF SUBCOMMITTEE ON SELECT REVENUE MEASURES HOUSE COMMITTEE ON WAYS AND MEANS

In an April 8, 1983, press release, the Subcommittee on Select Revenue Measures invited testimony on twenty-four specific questions. The mutual company responses to those questions are summarized in this appendix. Appropriate cross-references are provided where the question involves issues discussed in the text of our statement.

I. GENERAL POLICY ISSUES

1. Q: After identifying the various components of a life insurance transaction, how might the tax system best reflect these transactions?

A:

A contract which is designed to provide life insurance protection and which meets a proper definition of life insurance is essentially a unitary transaction and should be taxed as such. In general, tax law does not impute interest income to purchasers of goods or services who pay some or all of their purchase price prior to the vendor's performance. This is true even when the price actually paid is less than what might have been charged if payment had more closely coincided with delivery of the goods or services at issue.

Magazine subscriptions provide an illustrative example. A one-year subscription to U.S. News & World Report costs $36, but two- and three-year subscriptions, paid in advance, have an annual cost of only $31 and $29. For Fortune, the annual cost for advance-payment, one-, two-, and three-year subscriptions is $33, $30. and $25, respectively. And for another widely circulated magazine, while a one-year subscription paid in advance costs $22, a lifetime subscription is available for $250 (an estimated cost of less than $5.11 a year for a twenty-five-year-old male nonsmoker). Although any competitive magazine publisher will consider the time value of money when it prices long-term, advance-payment subscriptions, no one would suggest that transactions involving such subscriptions should be subdivided into a magazine "component" and an investment "component." The tax system does not, and should not, impute any investment "return" to the long-term subscriber, nor should it attempt to tax such an imputed "return" either directly or indirectly.

Historically, this principle has been applied to the actuarially based provisions of life insurance contracts. Term insurance becomes prohibitively expensive at higher attained ages of the insured. To make life insurance protection more affordable at such ages, companies offer policies with relatively level premiums, in which higher earlier premiums make possible lower later ones.

The pricing of such policies involves a synthesis of a large number of factors. These factors include anticipated administrative expenses, anticipated mortality, and the anticipated time value of money. The last factor is relevant because the amount of additional premiums charged in the early years of a policy is related to the present value of the later benefits to be funded. The unitary, integrated nature of a life insurance transaction is not lessened by the fact that the reduction in total charges is made possible by the presence of somewhat higher earlier payments. Nor may this fact be considered grounds for subdividing into putative components an integral contract whose goal is the provision of life insurance protection.

On the other hand, some companies in recent years have marketed contracts that may superficially resemble life insurance contracts, but that are actually designed to provide investment opportunities rather than insurance protection. The dominance of the investment goal is shown by the presence of contractual provisions that allow the development of a greater value in the contract than can be actuarially justified by the insurance benefits that the contract provides. Such inconsistency destroys whatever unity the provisions of such a contract might otherwise possess, and the inconsistency demonstrates the presence in the contract of a distinct investment component.

An investment vehicle of this sort should be divided for tax purposes into distinct components and should be so taxed to the policyholder and the company.

2. Q: How much tax incentive, if any, should be associated with life insurance to assist the public in purchasing adequate protection?

A:

The taxation of life insurance does not currently provide special incentives but rather is consistent with general tax principles. The purchaser of life insurance defers recognition as income of the annual increase in the cash surrender value of his policy. And upon the death of the insured, the tax on any excess of the policy benefits received over the premiums paid is forgiven. This treatment, however, is not peculiar to life insurance. It is merely the same treatment afforded to owners of other assets with unrealized appreciation.

As a general principle of taxation, only that income which is realized is subject to tax. The mere increase in value of an asset (for instance, one's home) does not, by itself, constitute realization resulting in the recognition of income. Rather, the receipt (or the deemed receipt) of income is required for the imposition of tax. Since the cash surrender value can be obtained only by terminating some or all of the protection provided by the policy or by suffering some other disadvantage, that value is not constructively received. Accordingly, no income is recognized as the cash surrender value appreciates. The treatment of increases in cash surrender value thus accords with the general rules applicable to appreciating assets.

Of course, if the contract is terminated and the cash surrender value received, the general rule provides that a tax should be imposed at that time on any gain. And this is the precise treatment that is applied to owners of life insurance contracts who terminate their policies.

Similarly, by means of a stepped-up basis, our tax laws provide that as a general rule, tax on unrealized appreciation is forgiven upon death. The tax forgiveness available to recipients of life insurance proceeds upon the death of the insured is thus analogous to the treatment provided all assets with unrealized appreciation.

3. Q: Are the various financial intermediaries who compete for investment and savings dollars able to do so on equal terms?

A:

Contracts that are designed to provide life insurance protection rather than investment opportunity serve a function that is different from the function served by products designed and purchased for investment. Life insurance that provides a meaningful amount of insurance protection is not in direct competition with bank accounts, money market funds, and similar investments and would not compete equally with them if it were. Conversely, such investments do not compete equally with life insurance because of their failure to provide adequate protection in case of the insured's death. The two types of products simply constitute different markets.

As is the case generally with products that occupy different markets, current law achieves tax equity by subjecting both types of products to generally applicable income tax principles. That life insurance contracts do not enjoy any competitive advantages is borne out by an examination of the facts. It would be reasonable to expect that if life insurance companies had an advantage as compared with other financial intermediaries, their share of total financial assets would be increasing. However, just the opposite is occurring. For example, in the 10-year period from 1971 to 1981, the amount of nonpension assets held by life insurance companies as a percentage of total assets held by financial intermediaries declined from 10.9 percent to 7.8 percent. By contrast during the same period the share of total assets held by banks, savings and loan associations, and money market funds increased from 63.2 percent to 66.6 percent. Similarly, in 1971 6.4 percent of the annual increase in financial assets of households was comprised of life insurance. By 1981 this percentage had declined to 4 percent.

On the other hand, investment contracts with only a thin veneer of insurance should be taxed in precisely the same way as other products designed for short-term investment. Since, unlike life insurance contracts, these products are in direct competition with garden-variety investment vehicles, they should, to that extent, be subject to precisely the same tax laws as the products with which they compete.

II. POLICYHOLDER TAXATION

4. Q: What is the historic or social justification for allowing the policyholders to receive tax deferral on the inside buildup in a policy?

A:

The rules governing the taxation of life insurance policyholders and beneficiaries are the same now as they have been since the first income tax law was enacted in 1913. These rules treat life insurance contracts in accordance with general tax principles. See Question and Answer 2. Policyholders are not taxed on increases in their cash values unless they realize this gain by surrendering their policies. In the case of surrender, however, the excess of the cash value over the premiums paid is fully subject to tax at ordinary rates. Finally, since death benefits are not subject to income tax, there is no tax on the appreciation at death.

These rules further several important social and tax policies. Indeed, the life insurance rules predate even the longstanding favorable treatment of certain retirement arrangements, which further related policies.

The function of life insurance, as properly defined, is to provide security against premature death to those who depend on the insured. Permanent life insurance developed as a practical means of providing this protection. The cost of term insurance greatly increases as the insured grows older. On the other hand, policy designs that allow for the growth of policy values make possible the payment of lower premiums in later policy years. This enables necessary protection to be maintained at higher attained ages of the insured. Permanent life insurance thus facilitates the purchase of insurance protection that can be maintained in force for a longer period of time.

It is important for a humane society to ensure that dependents are not left destitute when an important family member dies. For low- and middle-income families, privately obtained life insurance is the best way of achieving this goal. In 1982, 82 percent of all ordinary life insurance policies (which have cash values) and 67 percent of the total amount of insurance were purchased by individuals with incomes below $25,000. Placing a new burden on these individuals by currently taxing the inside buildup would inevitably reduce their ability to obtain insurance protection. In view of recent government benefit cuts and the severe financial pressures on the Social Security System, our tax laws should not be making it more difficult for individuals to act on their own to protect their families. Also, taxing death benefits would impose a burden on beneficiaries at the most inopportune time.

Finally, the current tax treatment of life insurance is consistent with the growing belief among lawmakers, economists, and others of many political philosophies that savings, and particularly long-term savings, should not be taxed (the consumption tax theory). In fact, according to prominent economists, the overwhelming majority of Americans already live in a consumption tax world. About 80 percent of assets held by individuals is in a form which permits exclusion of some or all of the related income or deferred taxation of this income. These include qualified retirement arrangements, owner-occupied housing, and social security.

A tax on income from savings encourages consumption and discourages the investment and capital formation necessary for the vitality of our economy. To correct this problem, either amounts that an individual saves should be deducted from his or her income -- as is the case, for instance, with IRAs -- or, equivalently, income earned on savings should not be taxed. Consistent with these ideas, even if it were realized, income from life insurance should not be currently taxed.

5,6,7 & 8. Q: To what extent should various types of life insurance products continue to enjoy tax preferred treatment as compared to other savings and investment products available to individuals?

To achieve comparability with other investments available to individuals, what would be an appropriate limit on the tax-deferred element of a life insurance investment?

Should limitations be placed on the amounts that may be invested in tax-preferred life insurance contracts?

If limitations are placed on the amount of deferral available to policyholders, should any resulting tax be imposed at the policyholder or the company level?

A.

As the response to Question 2 indicates, life insurance -- which is designed to provide insurance protection, not investment opportunity -- is not tax preferred when compared to analogous assets. Rather, it receives merely the same tax treatment as other appreciating assets. Since there are no limitations generally applicable to such other assets, no limitations would be appropriate for life insurance contracts.

Not all products, however, that are called "life insurance" merit the label. A meaningful definition of life insurance would prevent such a masquerade by products that are really short-term investment vehicles with only a thin veneer of life insurance. The proposal of the mutual companies would assure, through its definition of life insurance, that where a product is such an investment vehicle, the product will be held to contain an investment component that is to be taxed in a manner similar to other investments. Once this definition is implemented, both the investment component and the insurance component of the contract will be appropriately taxed, like analogous investment contracts or analogous appreciating assets, respectively.

9. Q: What are the emerging trends in the industry with regard to unbundling of the investment component of life insurance policies?

A:

Recent years have seen the growth of unbundled products such as variable life insurance and universal life insurance. This growth may or may not constitute a trend that will continue. For tax purposes, what matters is not whether the product is unbundled but whether it is a life insurance contract or an investment contract. True life insurance policies are characterized by a structural relation between life insurance protection (which is the goal of such policies) and the growth of value in the policies (which is merely a means to the end). Even if such policies separately analyze these two phenomena for the sake of consumers, this structural relation preserves the integral character of a life insurance contract. Investment contracts with merely a veneer of life insurance lack this structural relation and should therefore be taxed, at least in part, like other investments.

III. TAXATION OF LIFE INSURANCE COMPANIES

10 & 11. Q: How can the present three-phase system of taxing life insurance companies be simplified?

Should taxation of investment income and taxation of underwriting income be combined in a total income approach?

A:

The current three-phase system of taxing life insurance companies is irrational, overly complex, and unfair. The tax system should be simplified by imposing a straightforward, single-phase tax on a company's total economic income. Contrary to the contention of some companies, current law does not impose a tax on total income. Rather, the present system taxes some companies on amounts less than their economic income and others on amounts more than such income. In addition, the three-phase tax is unduly complex, even to those schooled in the niceties of tax law. These complexities have prompted one Tax Court judge, a jurist otherwise familiar with the Internal Revenue Code, to refer to the Byzantine scheme of life insurance company taxation as a "fantasy world."

A single phase tax based on economic income would substantially simplify life insurance company taxation. In providing for a single phase tax based on economic income, several specific criteria ought to be satisfied. These include the following:

- The law should allow a full deduction for all business costs, including all amounts paid or credited to policyholders.
- In recognition of commitments to policyholders, the law should allow a deduction for reserves actually set aside to satisfy such liabilities.
- The law should not distort competition.

12. Q: If companies are taxed under a system which segregates investment and underwriting income, what level of policyholder dividend deductions, paid out of underwriting gains, would be appropriate?

A:

a. Segregating Underwriting and Investment Income Would Perpetuate the Complexity and Tax Gamesmanship That Characterize the 1959 Act

Economically, a dollar is a dollar is a dollar. Any income tax structure that creates different classes of income in order to tax these classes differently ignores this basic economic truth. The inevitable result is tax gamesmanship and administrative complexity.

The gamesmanship appears as taxpayers attempt to transform disfavored income into economically equivalent, but less-taxed, favored income. Complexity follows as Congress and the IRS try to maintain artificial tax distinctions between economically fungible dollars. For instance, tremendous difficulties have resulted from the distinction for tax purposes between ordinary income and capital gains.

The difficulties under the 1959 Act are almost all due to its attempts artifically to classify income. For instance, modco involved shifting income between Phase I and Phase II. Conversely, the controversial consolidation regulations represent an administrative effort more permanently to characterize income by its Phase-of-origin. Moreover, the distinction between underwriting and investment income has led to innumerable, prolonged audit controversies.

No matter how careful the legislative craftsmanship, problems such as these would inevitably plague any tax system that attempts to segregate underwriting from investment income. The problems inhere in any situation where tax law makes a distinction that the taxpayer's economic reality does not.

Some proposals for such a distinction have been defended by characterizing the separate tax on investment income as an indirect tax based on special advantages allegedly enjoyed by policyholders. As we establish in our answer to Question 2, tax law equitably treats life insurance policyholders the same as it treats owners of analogous assets. As we establish in our answer to Question 4, exceedingly important social policy goals require continuation of the current tax rules for policyholders. These considerations of equity and social policy bar not only a new direct tax on policyholders but also any new indirect tax on policyholders by means of a tax on companies.

Moreover, even if one thinks of the separate tax on investment income as such an indirect tax on policyholders, the segregation still makes no theoretic or economic sense. By definition, the economic circumstances of policyholders would be the justification for a such a tax. Yet, according to the perspective of a policyholder who receives less expensive insurance, it does not matter from what sources the company derives the funds with which to provide the price reduction.

The following example demonstrates this point. Suppose that identical triplets (Tom, Dick, and Harry) purchase identical variable-cost life insurance policies from Companies _T_, _D_, and _H_, respectively. Suppose also that each individual's policy then provides a price reduction of fifty dollars. It makes no difference whatsoever to the policyholders that Company _T_ provided the benefit out of investment income, that Company _D_ provided it out of underwriting income, and that Company _H_ provided it out of surplus (in order to stay competitive with _T_ and _D_).

A special tax on life insurance companies that is based on the tax treatment of policyholders would be unjustified. Moreover, any such tax should reflect the equivalent circumstances of these three individuals. Accordingly, any such tax should not attempt to segregate the company's underwriting income from its investment income.

b. The Cost of Implementing Flexible Pricing Features Should Be Fully Deductible, Whether Paid Out of Underwriting Income or Out of Segregated Investment Income

Even if underwriting and investment income are segregated, the cost of implementing policyholder dividends and other flexible pricing features should be fully deductible. Regardless of their form, dividends and other flexible pricing features serve the same economic and competitive functions -- they allow companies to provide less expensive insurance protection to their policyholders. All policies having such features should be taxed in an identical fashion. Any meaningful measure of underwriting income, therefore, should allow a full deduction for the company's cost of implementing such mechanisms.

Moreover, notwithstanding any segregation of underwriting and investment income, a full deduction should also be allowed for the portion of the cost of flexible pricing features that is paid out of investment income. From the separate perspective of a life insurance company's investment income, an underwriting loss is properly allocable as an expense of producing the investment income. A bank that provides gifts to those opening new accounts properly considers the gifts to be one of the costs of producing its investment income. Analogously, a life insurance company may provide insurance protection at an underwriting loss and thereby obtain the premium revenues from which its investment funds are drawn. A company writing fixed-price policies may price its products in this way, and it then receives a full deduction for its underwriting loss in providing the insurance. The fact that flexible pricing features may be the mechanisms used to adjust the price of this protection does not prevent the associated expenditures from being properly allocated as one of the costs of producing the company's investment income.

When interest rates are high, competition with other insurers often forces a company issuing variable-cost policies intentionally to incur such an underwriting loss. That is, as a result of implementing flexible pricing features, the company offers protection at a cost to the company that exceeds the sum of the policy's cost to the policyholder plus the assumed interest earned by the company. If it did not offer insurance at an underwriting loss, the company would not have earned the investment income at issue.

The company offsets this underwriting loss against a portion of its investment income (that is, with a portion of the excess of the company's investment yield over its assumed interest). The remainder of the investment income constitutes the company's economic income. Under a comprehensive income tax, that remainder -- the company's economic income -- ought to be the company's tax base. Even if the tax base is segregated investment income rather than economic income, the underwriting loss should be deductible from gross investment revenues as a necessary cost of producing the investment earnings to be taxed.

The illogic of denying such a deduction becomes even more striking if a second analogous banking situation is considered. Some banks provide their customers with minimum-deposit, no-service-charge checking accounts. Since the amount paid by such a bank's customers for the accounts (nothing) does not cover the cost to the bank of servicing the accounts, the bank plans to incur a loss on the operation of the accounts. This loss corresponds to a life insurance company's underwriting loss due to flexible pricing features. The bank expects, however, substantially to make up for its loss on the operation of the accounts out of investment income earned by the bank on the checking deposits. It would make no sense to deny a bank the right to use a cost-of-providing-service deduction to offset some of the investment income that the bank earns on the deposits in the no-service-charge checking accounts. Similarly, it makes no sense to forbid life insurance companies to deduct from their investment income their expenditures in using flexible pricing features to provide policyholders with life insurance protection.

13. Q: Given the current general industry practice of using a preliminary term method for calculating reserves, can the provision for revaluing to net level reserves be eliminated?

A:

Mutual companies believe that the approximate revaluation method of section 818(c)(2) should be eliminated. In many cases, the approximate method produces inaccurate results and is in general unnecessary with modern computer technology. Also, in the context of a single phase gain from operations tax base, other limitations on reserves might be considered such as limiting companies to using the same reserve basis for tax and annual statement purposes or limiting companies to some generally recognized reserving method. See Statement at 13.

14. Q: If revaluation of reserves to net level reserves is retained, how should the problems presented by graded premium products be addressed?

A:

The problem presented by graded premium products, which contain elements of whole life insurance and term insurance to varying degrees, is that the reserves computed for these policies under the approximate revaluation method far exceed reserves as computed on a net level basis. See S. Rep. No. 97-494, 97th Cong., 2d Sess. 341 (1982). This problem would be remedied by eliminating the approximate revaluation method. See Statement at 13.

15. Q: What is the justification for special deductions for contingency reserves for nonparticipating contracts, group life, and health and accident contracts? Are they still necessary?

A:

Under current law, a special deduction equal to the greater of 10 percent of the annual increase in reserves or 3 percent of annual premiums is generally allowed with respect to nonparticipating contracts issued or renewed for periods of five years or more. Current law also provides a special deduction generally equal to 2 percent of group insurance premiums. These special deductions are sometimes referred to as deferrals since they are theoretically taxable in Phase III. As a practical matter, however, the companies that can take advantage of these deductions enjoy permanent tax forgiveness. Contrary to Congress' expectations in 1959, virtually all companies potentially subject to the Phase III tax can avoid it at will.

When originally enacted, the special deduction for nonparticipating policies was defended as providing a "cushion" for stock companies, which were believed to maintain relatively larger surplus and capital accounts with respect to their policies than did mutual companies. Participating policies, such as those written by mutual companies, were believed usually to require higher initial premiums than nonparticipating policies. If, in the case of participating policies, the company's experience is as expected, a portion of the premiums will not be needed and will be returned to the policyholder or otherwise credited to his policy. This excess portion provides the issuing companies with a "cushion" that could be used to meet various adverse contingencies. As this "cushion" is unavailable in the case of nonparticipating policies, the special deduction was enacted to provide comparable liquidity protection.

The special deduction for group insurance was defended on analogous grounds. It was argued that since the insureds under a group policy share a single, common characteristic, the company's risk diversification is less than optimal. If that characteristic is ultimately found adversely to affect the group's mortality, reserves might prove inadequate, and capital and surplus would be burdened. The special deduction was intended to provide for such events.

The absence of economic justification for these deductions has been demonstrated, however, by experience during the last quarter century. In that period neither nonpar nor group policies have proved significantly more risky than other types of policies for which no special deductions are granted. Thus, the "cushions" provided by these special deductions appear in fact to have been unnecessary. To compound the problem, some companies today are claiming the nonpar special deduction even for policies that are the economic equivalent of participating policies.

The absence of an economic basis for the special deductions is further demonstrated by comparing the arguments in support of these deductions with the justification for deductions attributible to life insurance reserves: While deductions attributible to life insurance reserves are made on account of a predicted liability, the special deductions are made on account of hypothetical liabilities in excess of those actually predicted.

Thus, regardless of the validity of the concerns that the special deductions purportedly address, neither deduction is economically warranted. Essentially, both deductions are defended on the grounds that, due to possible subsequent adverse circumstances, amounts that were initially believed to be income in a policy's early years may ultimately be found to be necessary to provide for the payment of policy benefits. But the special deductions are available whenever nonparticipating and group insurance is written, regardless of whether favorable or unfavorable experience ensues. Thus if favorable underwriting results occur, the special deductions provide a windfall.

Since the special deductions are intended to provide for a contingent detriment, any relief that the tax laws make available also ought to be contingent.

The problem to be addressed is experience that turns out to be less favorable than that which was assumed in setting up the reserves. This problem, which is characteristic of all life insurance, can be adequately provided for by loss carrybacks. There is no economic justification for providing a deduction to compensate for hypothetical liabilities in excess of those reasonably predicted by the taxpayer.

Moreover, because the special deductions are not available to mutual companies, they afford the stock companies an unfair competitive advantage in pricing their products. This advantage is especially pronounced in the group insurance area, which is highly competitive and is characterized by thin margins of profitability.

The one-sided nature of the special deductions is consistent with the belief of many that these deductions were never motivated by economic considerations. Rather, a substantial body of evidence suggests these deductions were just some of the mechanisms by which the life insurance industry's federal tax burden was allocated in a predetermined manner among the various segments of the industry (*i.e.*, "segment balance"). The draftsmen of these provisions were merely searching for rules that would yield a foreordained result. As such, the provisions do not have, and never have had, any economic justification. Indeed, rather than reflecting economic reality, they are designed to enable some taxpayers to be taxed on less than their economic income.

In sum, if a special treatment is desirable to provide liquidity protection for life insurance companies, then an extended carryback may be appropriate in lieu of the noncontingent special deductions.

16. Q: Should deductions for excess interest and premium adjustments be subject to the same limitations applicable to policyholder dividends?

A:

Most life insurance written today involves variable-cost policies that provide the policyholder with less expensive protection when the company enjoys favorable experience. For the foreseeable future, interest rates appear likely to fluctuate, and life expectancy is expected to continue to improve. As a result, consumers today demand life insurance products in which the policyholder will benefit if the company enjoys a favorable investment climate ("investment experience") or a favorable claims history ("mortality experience").

Such company experience, actual or projected, can be passed on to the policyholder in the form of either increased protection at the same price, the same protection at a reduced price, or a combination of the two. The flexible pricing features that may be used to pass on the favorable experience include premium adjustments, discretionary excess interest, indexed excess interest, the analogous portion of variable death benefits, and traditional "policyholder dividends." Regardless of their form, all of these flexible pricing features serve similar economic and competitive functions -- they allow companies to reduce the net unit cost to the policyholder of his insurance protection.

The cost to the company of providing those flexible pricing features should be fully deductible or excludible in determining taxable income. See Statement at 14-16. But if a limitation is imposed on the deductibility of any of them, all should be subject to the same limitation. It should make no meaningful difference whether the company pays policyholders a "dividend" of fifty dollars or informs them that the next premium has been reduced by the same fifty dollars. Similarly, it is immaterial whether the company adds to the value of a policy a fifty dollar "dividend" that is being used to purchase paid-up additions or whether the company adds the same fifty dollar value to the policy at an articulated excess rate.

Given the substantial economic equivalence of these flexible pricing features, they should have equivalent tax consequences under any new legislation. Since an income tax should be based on economic reality, equity among similarly situated taxpayers requires that tax law treat such economically interchangeable features the same. Moreover, unless social policy favors one or more of these features over others, economic neutrality requires all of them to be treated equivalently in order to avoid distorting the marketplace. Since these features all serve the same function, if tax law favors one or more of them, most policies will be written or rewritten to enjoy that advantage.

Accordingly, if legislation allows a company less than a full deduction for the cost of implementing any one of these flexible pricing features, then deductions for implementing any of the others should be identically limited.

17. Q: What is the most appropriate way to reflect the equity-ownership element in policyholder dividends?

A:

Mutual companies do not believe there is any significant equity ownership element in policyholder dividends. The nature of policyholder interests varies greatly from that of corporate shareholders. Policyholders, for instance, cannot market their interests to realize capital appreciation.

Even if mutual company policyholders are treated as equity owners, there is no need for special tax law provisions if an economic income approach, such as proposed by mutual companies, is used. Any purported policyholder equity interest must be acquired by premium payments which are fully included in the mutual company's income under an economic income approach. In contrast, capital contributed by shareholders, the means by which their equity interests are originally acquired, is not subject to corporate tax. The inclusion of the "equity ownership" component of premiums in mutual company income is economically equivalent to the normal corporate treatment of excluding capital contributions from corporate tax and fully subjecting the return on this capital to such tax.

Accordingly, there is no need for the treatment of policyholder dividends or any other item to be altered to reflect any purported policyholder equity ownership at the company level. See Statement at 14-16, 20-23.

Finally, if the presence of flexible pricing features is deemed to create an equity interest in the policyholders of a mutual company, it must do the same for the policyholders of a stock company. The existence of a formal equity interest in the stock company's shareholders is no barrier to the existence of whatever different equity interest is deemed to be created by flexible pricing features.

18. Q: Should the definition of a life insurance company be revised to reflect changes in the product mix offered by the companies?

A:

If life insurance companies were taxed on their economic income like all other corporate taxpayers, such equitable tax treatment would put an end to almost all of the present tension in the law that is engendered by the definition for tax purposes of a "life insurance company."

19. Q: How should qualified pension business be treated for tax purposes to ensure competitive neutrality with uninsured pension plans?

A:

Insured pension business must be treated on the same basis for tax purposes as noninsured pension plans to ensure competitive neutrality. Accordingly, life insurance companies must be allowed a full deduction or a full exclusion for all amounts credited to their pension plan business. Of course, a life insurance company should not be allowed to deduct or exclude amounts in excess of those attributable to, or actually credited to, pension plan business. Once the basic structure for the permanent tax law is developed, a system can be designed to allow an exclusion of no more and no less than amounts actually credited by life insurance companies to pension plan business. See Statement at 16.

Insurance companies also compete with tax-exempt trusts and other tax-exempt media for funding employee welfare plans. As with qualified employee pension plans, parity should be provided between the tax treatment of insured and noninsured employee welfare benefit arrangements. Thus, any amounts credited to employee welfare benefit business should also be fully deductible or excludable. See Statement at 17.

20. Q: What is the justification for any special provisions for small life insurance companies?

A:

Justification for a tax incentive for small mutual and stock life insurance companies is to foster competition. The incentive could be provided in recognition of the high costs of developing new insurance business, the highly competitive nature of the insurance business, and a predominance of large companies in the industry that benefit from economies of scale. See Statement at 28.

Q: If there is a justification, what is the appropriate definition of a "small life insurance company"?

A:

We have no specific recommendation and would suggest that the Subcommittee consider suggestions from the industry organization representing smaller companies, the National Association of Life Companies (NALC). However, any incentive for small companies should be limited to small companies. Also, the definition should apply to related corporations on a group basis so that large, established companies do not benefit from the provisions merely by operating through newly formed corporations. See Statement at 28.

21. Q: How can Congress continue to assure that reinsurance transactions are not used by the industry to avoid tax liability?

A:

The use of reinsurance as a tax planning device is entirely a creature of the phase system of the 1959 Act. Under the phase system, the same item of income may be taxed at 46 percent in the hands of one company, at 23 percent in the hands of another, and at a zero rate to yet a third. The tax value of deductions for expenses also varies correspondingly. Moreover, investment income and expenses are taxed differently from underwriting income and expenses. All of these variations under the phase system make it profitable for companies to arrange reinsurance transactions to allocate income and expenses to maximize the tax benefit.

The best way for Congress to assure that reinsurance transactions are not used to avoid taxes is to entirely eliminate the phase system. If, instead, all companies are taxed on economic income, tax liabilities will not be affected by allocations of income and expenses under reinsurance transactions. We do not believe there is any other way that Congress can be assured that reinsurance or some other tax planning device will not be devised to take advantage of the inevitable distortions of the phase system.

22. Q: What mechanism, if any, should be used to assure that all insurance companies pay their minimum share of taxes? How would such a minimum tax be structured?

A:

The best mechanism to assure that all insurance companies pay their fair share of taxes is to design the permanent tax structure to measure a life insurance company's economic income. This approach constitutes the bedrock of corporate income taxation generally.

There are some circumstances, under the general corporate income tax system, where a company's tax base may be zero, or less than zero, even though the company has really recognized an economic gain. Corporate minimum tax provisions (Code section 56) and special rules relating to corporate preference items (Code section 291) are designed to ensure that such companies pay a minimum level of tax. In this regard, insurance companies should also be treated like corporations generally.

To the extent that a life insurance company's income is offset by business costs, the company, like corporations generally, has not experienced an economic gain and so should not be taxed. However, we realize that, for revenue or other reasons, consideration might be given to taxing life insurance companies on a minimum amount of income. We are willing to assist in the evaluation of an appropriate tax base for these purposes.

IV. TRANSITION ISSUES

23. Q: If the phase system is eliminated, how should the existing "overhang" of deferred income be treated? Should there be recognition over an appropriate spread period?

A:

As this question recognizes, large amounts of taxable income have been deferred under the phase system of the 1959 Act. Although the 1959 Act contains mechanisms specifically designed to eventually include the deferred amounts in taxable income, virtually no tax has been paid on the estimated $9 billion in income that has been deferred. It is also doubtful whether these deferred amounts are needed to provide a cushion for contingencies, as originally contemplated. Reserves established by companies have been adequate for contingencies. Moreover, the large amounts of shareholder surplus held by most large stock companies indicate that the extra cushion provided by the deferred amounts in the policyholders surplus account is unnecessary.

These conditions suggest that there is no reason to continue the deferral of these large amounts of taxable income. To avoid the triggering of large deferred-tax liabilities all in one year, however, the deferral might be terminated gradually over a period of years.

24. Q: In the event of major structural changes in the tax treatment of life insurance companies and their products, what transition problems are presented with respect to existing products?

A:

Because of the long-term nature of insurance contracts, it is extremely important that a sound permanent tax law be enacted so that companies can design and price their products with some certainty. However, for the same reason, any major change in the tax treatment of life insurance companies and/or their products can have a substantial adverse impact on companies and their policyholders. Accordingly, transitional rules will be needed.

Clearly, any adverse change in the policyholder taxation of products should apply only to new policies. The basic rules concerning policyholder taxation of life insurance products are well established. Policyholders will have relied, probably in important respects, on the tax treatment of the policies. It will also be noted that there is recent precedent for the grandfathering of old contracts in the stopgap amendments relating to the taxation of annuity contracts and universal life policies.

On the company side, any substantial change in the level of tax on life insurance products should also be applied only with respect to new business. In many cases, the premium structures for policies are set in advance and are fixed for the duration of the contract which may span decades. The premium structure reflects the issuing company's projection of all expenses, including taxes.

A specific area where transitional problems will be presented in the event of major change concerns the tax treatment of reserves. Because of the phase system, companies have received different degrees of tax benefits from reserve deductions. On the one hand, it would be unfair for any adjustment to result in a tax increase exceeding the tax benefit previously derived from the corresponding reserve deduction. On the other hand, attempting to identify and measure prior tax benefits will involve enormous allocation problems. If major structural changes are made in the taxation of life insurance companies, including changes in the computation of reserves, we would urge that all companies be allowed to compute reserves as of the beginning of the year of change on the basis mandated by any new law, to avoid these difficult transitional problems.

APPENDIX C

Inequitable Tax Burdens Under The 1959 Act

Perhaps the best way to understand the underlying flaws in the 1959 Act is to analyze how the tax base under the Act differs from economic income. The tax base may essentially be derived from economic income, as reported on the company's annual statement, by adjusting income upward by one noneconomic factor (dividend disallowance) and by adjusting it downward by up to five noneconomic factors (preliminary term revaluation, the nonpar special deduction, the group life and A & H special deduction, the "phase II deferral," and the small business deduction).

The historical evidence suggests that the noneconomic adjustments were motivated by a desire to influence the relative tax burdens borne by stocks and mutuals. The actual impact of the adjustments, however, depends more on the nature of a company's insurance products than it does on a company's form of organization. Thus, the 1959 Act unfairly discriminates between a dollar of income from one type of policy and a dollar of income from another.

To observe this, consider three hypothetical companies. All use the same accounting system, all have the same financial statement income, all retain the same net income, and all three are exclusively engaged in the business of providing economic protection in case of death. As will be seen, however, despite the identity of the companies' economic income, the 1959 Act imposes strikingly different tax burdens on them.

Company A is a stock or mutual company selling only participating whole life insurance. All of the life insurance policies that Company A sells have assumed rates of interest which were appropriate when the policies were issued, and none of its business is on a preliminary term basis. Since Company A returns a large portion of its gain as dividends to policyholders, its economic income is adjusted upward as a result of the limitation on the deduction for the cost of providing such benefits. The company enjoys no downward adjustments other than the nominal subtraction for the "small business deduction."

Company B is a company selling nonparticipating whole life insurance. (Thus, we may infer that it is a stock company.) These life insurance policies, like those of Company A were sold in yesterday's economic climate, but they are very much a part of Company B's current business. Company B does not pay any policyholder dividends. No portion of Company B's business is valued on a preliminary term basis, and its particular tax advantages flow from the downward adjustments for nonparticipating contracts and for the phase II deferral.

Company C is a company selling nonparticipating contracts, which pay no dividends. Company C's policies were all sold on a preliminary term basis, and its primary tax subsidy is through the preliminary term revaluation.

Table 1 on page C-3 illustrates the tax consequences to these companies of deriving their income from these different types of policies. The flow of income and the reflection of expenses is different in each company to reflect the attributes of the different products and the periods in which they were sold, but the so-called "bottom line" is the same in each case. The tax results, however, vary dramatically from one company to another. Company A's tax rate is 84%, Company B's rate is 32%, and Company C's rate is 22%

Although the illustrations depict hypothetical, not actual, companies, it should be noted that by 1979, of the 1291 companies incuded in the A. M. Best annual statement data base, perhaps 550 paid no federal income taxes; maybe 450 others had effective tax rates of less than 30%; and about 20 companies, mostly large mutuals with a significant percentage of participating whole life business, had effective tax rates of 60% or more, all measured on a consistent accounting basis.

C-3

TABLE I

TAX LIABILITY OF HYPOTHETICAL COMPANIES
(000 omitted)

	COMPANY A	COMPANY B	COMPANY C
Revenue:			
Premiums	$ 112,133	$ 92,150	$ 87,366
Investment Income	55,832	38,596	36,590
Expenses:			
Expenses incurred in production of income	21,061	13,158	12,474
Less Benefits:			
Death Benefits	14,774	16,307	10,428
Less Reserves Released on Death	(7,912)	(8,684)	(183)
Surrender, Other Benefits	28,556	32,360	9,788
Less Reserves Released on Termination	(27,328)	(31,009)	(9,050)
Reserve Increases	79,953	88,614	80,499
Refunds	38,861	0	0
Financial Statement Net Income	$ 20,000	$ 20,000	$ 20,000
	PLUS ADDITIONS		
Dividends to Policyholders	16,574	0	0
	LESS SUBTRACTIONS		
§818(c)	0	0	8,316
Non Par	0	2,368	2,245
Group Life/Health	0	0	0
Section 802(b)(2) Deferral	0	3,338	0
Small Business	25	25	25
Tax Base 1959 Act	$ 36,549	$ 14,268	$ 9,414
Tax	$ 16,812	$ 6,563	$ 4,330
Effective Tax Rate	84%	33%	22%

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*/ This is an effort to illustrate the tax impact on the business of selling life insurance policies; not an illustration of the tax on any particular company. For simplicity, we assume the policies are not sold in the "pension" market; all investment income is fully taxable and the corporate tax rate is a flat rate of 46%. We also ignore any Phase III tax.

Chairman **Stark**. I guess I want to save a question until the end, and you all might be thinking about this. As you know, this morning Secretary Chapoton suggested imputing some, as he said, "corporate profit" to your policyholder dividends, and I am sure that you have all touched on that in a variety of ways. I will come back to that later.

A couple of other things. In your testimony you discuss the problem of determining the long term obligations to policyholders.

Now, aside from whatever guaranteed cash values there are, wouldn't, as a maximum, your own long term, decreasing term rate adequately cover that liability? If you had an endowment policy that matured at age 65 and you also wrote a term for age 65 and the at-risk portion of the endowment and the term followed approximately the same curve, wouldn't basically the premium of that term policy cover your risk? It might be less, but I mean certainly that would be enough, would it not?

Mr. **Van Fossan**. Coleman Bloomfield, do you want to attempt to respond to the chairman on that?

Mr. **Bloomfield**. I will attempt to. I am not sure I fully understand the question, but I think the answer to your question is yes, that in theory there is no difference between the decreasing term element component of a permanent life insurance policy, if you want to separate it out, and a decreasing term insurance policy, assuming that you ignore all expenses related to the acquisition of one and the maintenance of one relative to the other. But essentially, you can cost out those two products.

Chairman **Stark**. I guess what I am saying, and you have then answered my question, is that really it is not impossible at any point in time to calculate the long-term liabilities in some determinate manner if you say that they certainly can't exceed either an investment pool large enough so that the earnings on that pool will pay a term premium, or that there is an income stream that will fund it.

Mr. **Bloomfield**. Well, let me just add this comment, that in either case, whether you are dealing with the so-called term component of a permanent policy or decreasing term policy by itself, the costs of either one are really not determinable at the date of issue. And of course, therein lies really the fundamental concept of traditional participating insurance, and that is, not knowing the future costs over the next 30 or 40 or 50 years of either product.

Therefore, we design a product which carries a fairly conservative premium and which permits refunds of a portion of that premium to the policyholder.

Chairman **Stark**. I suppose that I would agree in theory, but in actuality there is no risk that any of you carry in your portfolio that couldn't be reinsured. Therefore you could at any point in time get an exact cost of laying off that insurance risk to one of your brothers or sisters in the industry.

So although that may still be more expensive than you would like it to be, there is, it seems to me, at any point in time a determinate dollar amount.

Mr. **Bloomfield**. It is not only more expensive. It has to land somewhere. If it doesn't stay with the original writing company, it goes to the second company, and that company has essentially the same problem.

Chairman STARK. So in theory it is difficult, but in fact we could get at some kind of a number that would satisfy, in the microsense, a particular company at a particular point in time.

Mr. CREEDON. If I may, Mr. Chairman, I think one of the complicating factors, and Coleman referred to it somewhat, is that frequently these policies exist for 60 years or 70 years or 80 years. When you set the premium initially, you are setting a premium which is intended to deal with, first, the risk of death; second, the expenses; and third, you take into account some kind of an appreciation or investment return on the excess premium.

But the expense factor alone is a tremendous factor—to go back and look at a policy we issued 60 years ago, and look at the inflation that has taken place in expenses since that time—this is one of the complications in deciding what kind of premiums you need and what kind of reserves you need.

Mr. BLOOMFIELD. May I add an additional comment, that another complication—and we need only go back about 25 years to examine this one—is that the level of interest rates has strayed all over from approximately a 3-percent level to something in excess of 15 or 16 percent in the period of 25 years.

So in setting the premium rates for permanent insurance, it is difficult, impossible, I might submit, to forecast today precisely what interest rates we will be able to generate over the next 25 or 30 or even 2 years, for that matter.

So were we able to do this, were we as companies able to determine precisely the cost, the mortality cost and the interest returns, it would be fairly simple to come up with an exact premium and have no risk related thereto.

Chairman STARK. It would be the Chair's impression that the mortality costs have been rather precise in the industry and have done nothing but decline over the history of mankind. That historically, at least, as to the interest rates, there was an awful long time when you were operating in a band of 2 to 6 percent, so that it is only since approximately 1965 that you have gotten out of that band of a base of 2 and a ceiling of 6.

I would also submit that if you really wanted the price of product for a 30- or 40-year time in the days when you made 30- or 40-year investments, you could close both ends of the contract at the inception and lock in at least your spread, if not your profit. You could lock in your overhead.

So I have a hunch that it is not that germane, but I have always questioned the idea of whether this indeterminate termination of the contract is that big a factor.

There is also the statement that has been made at a variety of times about insurance as an appreciating asset. I really question if life insurance is an appreciating asset, as one might think of collectibles or gems or farmland, with an indeterminate market value or one affected by inflation in a positive rate.

For the traditional products, in general the face amount does not increase, leaving out the effects of any dividend distributions. You generally buy a face amount and that stays constant.

So I think generally there is no appreciation in the death benefit, and the whole life contracts generally have a fixed increment of value, much as somebody buying a series E bond. As matter of fact, that is probably a pretty good example because we don't tax the buildup in that either. But one doesn't tend to think of an E bond as an appreciating asset.

I wonder, is that definition or is that characterization really accurate?

Mr. CREEDON. I think the appreciation that is being referred to when that is mentioned is the difference between the cash value and the face amount at the time of death. In other words, you have a certain basis in the policy compared with the amount that is payable at the time of death.

So I think what is being referred to there is the fact that the amount realized at death is an increase over and above the basis that the taxpayer had.

Chairman STARK. The basis being the amount of premiums paid in?

Mr. CREEDON. Well, yes, and the comparison may be to real estate which was acquired for $10,000 and worth $30,000 at the time of death. No income tax is paid at death on the increase in value.

So if you bought a life insurance policy for $100,000 and paid $2,000 in premiums and then died, the $98,000 is an increase in value, but it is comparable to other types of assets.

Chairman STARK. OK, one other item. Maybe you are saying the same thing, but in your testimony, in tab B, on page 4 of tab B I believe, B-3, the question that we asked is how much tax incentive, if any, should be associated with life insurance to assist the public in purchasing adequate protection.

In your answer you said that the taxation of life insurance does not currently provide special incentives, but rather is consistent with general tax principles. We defer recognition of income and there is no tax at death.

On the other hand, at page 24 of your testimony you say that the tax law has always been designed to encourage the purchase of insurance so that dependents are provided for in the event of a wage earner's death, and that this important social policy should be continued.

I wonder if there isn't some dichotomy there in that answer. Are those identical statements?

Mr. GROOM. Maybe we should respond to that, Mr. Chairman. I think we regard those as alternative arguments. On the one hand, we think that——

Chairman STARK. Depending on which way I am going, okay. Two alternative solutions.

Mr. GROOM. We have some other reasons as well.

Chairman STARK. Let me now come back to asking the final question of any of you or several of you. If Mr. Chapoton's suggestion were to prevail, can anybody suggest to the committee some method for determining what percentage of your investment assets ought to be considered for the purpose of arriving at a tax base to determine a shareholder's equity?

Let me give you an example. I am talking here about, and I hate to use the words "monumental reserves," but I suppose many companies may find that they have a tremendous value in the portrait of their previous chief executive officer, which hangs in the lobby of their large granite and lime building. And rather than sell that portrait to a museum and realize it, the mutual company decides to keep that portrait as an asset.

Or the rolltop mahogany desk, or indeed, the eight-story vaulted entrance to a building may not be the most useful asset at this point, but there are some assets that are accoutrements of an ongoing enterprise that might be considered—and some might earn something, but might be considered just part of the enterprise and necessary to continue.

Another approach might be that if somebody were to start a mutual company today, under the laws of some States I am sure there is some kind of a capital base that somebody has to pony up, either in the form of prepaid premiums or in the form of some kind of a kitty to get the enterprise going. That, it seems to me, would be a measure of a percentage of assets, the earnings on which could be considered as similar in nature to a stockholder's dividend in a stock company.

How can we, if it is determined that this is a way to make some sense or balance out of the different ownership structure in the two types of companies, can you all suggest any ways that we might find to measure those differences? It would be helpful. Anyone can take a shot at it.

Mr. **Van Fossan**. I will attempt to respond briefly first and then call on any of my associates.

First, I would suspect, Mr. Chairman, that the investment value of former chairmen's portraits resembles that of your former wife's diamond. [Laughter.]

Mr. **Guarini**. Or the Ways and Means hearing room, I might suggest. [Laughter.]

Mr. **Van Fossan**. Very frankly, the suggestion outlined this morning by Assistant Secretary Chapoton was the first that I am sure most of us had heard that particular idea espoused. I personally would not feel it should be rejected outright, but I think it would bear some extensive study.

I don't know that I understood precisely what he was saying. Nor am I sure that too many others really understood. If his inference was that some portion of the premium that a mutual company policyholder pays is an investment in the assets of the company as an ownership interest, and then proportionately some percentage of the dividend is a return, that is one thing. But I am not sure that is what he meant.

We would say to the committee, very frankly, that we would stand ready to work with the Secretary and with your committee to pursue what, if anything, might lie behind that suggestion.

Chairman **Stark**. I think what he was basically saying was that we are in an ever-reducing radius if we keep arguing policyholder dividends, and is it a policyholder dividend or is it in the nature of a stockholder dividend, and suggest that because, rightly or wrongly, the United States now had a double tax on stockholder dividends in corporations and that somehow to approximate that taxation level there has got to be a way to grind in a factor in the calculation of taxes for mutual life insurance companies.

And I do not know that he went any further than that, quite frankly, and I am not suggesting that I am asking any of you to agree or disagree. I am just now saying, if that is an approach we are going to take, do any of you have any ideas on any kind of a routine or procedure that we might use that could lead us to some sensible calculation?

Mr. CREEDON. I just have two brief comments: One, I would like to reemphasize what Mr. Bloomfield said about how money that comes into a mutual company is taxed. When the policyholder pays a premium, that premium comes into the income stream of the life insurance company and is taxed. And he gave the example of it being taxed essentially at 46 percent, and so it is being taxed there.

Now, within the company, if it earns money, it is taxed again. I think a very important point to recognize in connection with this mutual-stock argument is that a mutual policyholder is not like a stockholder. He does not have a share of stock. He does not include that stock in his estate. He does not sell it on the stock exchange.

What he has is a contract which gives him certain rights. Now, if you regard part of his interest in the company as being an ownership interest, that ownership interest is returned to him when he dies or when he surrenders his policy.

So part of the money that is constantly going back in the form of dividends is a return of the original contribution, if you regard him as having made a contribution to a company, which is comparable to what the stockholder contributes.

Mr. ZINN. I think we would only add, Mr. Chairman, as we did during our discussion with you, that the rights of the mutual company policyholder do not approach those of a stockholder of a major stock company. He cannot sell that whenever he wishes, he cannot obtain the same kind of capital appreciation that is obtainable by a stock company's stockholder.

So I would say that the beginning point to trying to measure under the approach that Mr. Chapoton suggested would be to recognize that if there is any differential it is very tiny and minor in relation to that of a stockholder of a stock company.

Chairman STARK. Just out of curiosity, has there ever been a class action suit against mutual companies where a policyholder on behalf of all policyholders sues for any particular amount of money on any issue?

Mr. VAN FOSSAN. I am not aware of any, Mr. Chairman.

Mr. ZINN. I am not aware of any.

Mr. GUARINI. It sounds like it would be a nightmare.

Chairman STARK. It sounds like a nightmare. I am thinking of my grandfather's policy, which was issued just before Northwestern Mutual raised the amount that everyone was going to get, and I think I missed that by a year or two.

Mr. ZINN. We would hope that you were not a policyholder of the mutual company then, Mr. Chairman.

Chairman STARK. I see.

Mr. GROOM. Mr. Chairman, I might raise a procedural question with you at this point. One of the witnesses on one of the subsequent panels is Dr. Mike Boskin. He has a problem which you might appreciate, being a Californian. He came here today for the hearings. He is trying to catch a 5:30 plane back.

The thought occurred to me that possibly you might receive his testimony now and then proceed further with this panel.

Chairman **Stark**. I am most sympathetic to his schedule, and, if the committee would not have any objection, I would be glad to give him a couple of minutes right now.

Mr. **Duncan**. Mr. Chairman, I would object, unless you are going to give us an opportunity to ask questions. We have been waiting for an hour. If he is going to be 5 or 10 minutes, I would have no objection. But if it is going to be a long colloquy, I would object.

Chairman **Stark**. I would suspect that, if I understand, his testimony will be limited to 5 minutes or less.

Mr. **Duncan**. I have no objection.

Chairman **Stark**. Thank you.

STATEMENT OF MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **Boskin**. I am Prof. Michael Boskin of Stanford University. I appreciate the opportunity to be here and to see you again, Mr. Stark, and a few other members of the subcommittee. I would like to summarize just a few points that appear in my written testimony, and comment on one or two of the statements that were made previously concerning the taxation of mutual versus stock companies.

My testimony is mostly devoted to conceptual issues about how one ought to treat life insurance in the context of an ideal tax system. It deals with issues such as integration of the corporate and personal tax and the recent move of our tax system, the good news being moving part way from the double taxation of saving under an income tax and more toward single taxation of saving, as would occur in a comprehensive personal consumption tax.

These principles are embodied in such things as the move to universal IRA accounts and have long been embodied in our special notions about the tax treatment of social security, which is only beginning to be taxed even at withdrawal with the new proposals, the tax treatment of housing, and the inside buildup in life insurance.

I would like to make four or five quick points. First of all, while the structural ideal of an integrated corporate and personal consumption tax may not be achievable in the short term, it seems to me that it would behoove this subcommittee and the Treasury and our society that any changes in the life insurance tax treatment be part of, or thought of as an integral potential part of, a move in these directions, and that we not make any retreat from the substantial achievements that have been made in the last two administrations toward moving our hybrid of a corporate and personal income tax toward consumption tax treatment, and away from income tax treatment, where corporate-source income and savings are taxed once, not twice.

Second, it seems that, with the severe structural deficits we face in the years ahead, it would be most strange indeed if the way we chose to curtail those deficits or reduce them would be to increase taxes on savings. That is, if the deficits are a problem, they are a problem because they will sap the pool of available saving, drive up interest rates, and decrease our long-term capital formation.

So it seems kind of strange to be trying to solve a problem which is a problem because of our low-saving rate—it would not be one if we had a saving rate of 25 percent like the Japanese and Western Europeans do—by raising taxes on saving and reducing our potential long-term saving.

Finally, as stated in my introductory remarks, these principles ought to be applied to all types of reinvested income. They apply not just to life insurance or one particular legal form of a life insurance company.

In that context, then, I think this subcommittee well knows the enormous increase in effective marginal tax rates that occurred in the 1970's due to the particular mechanical features of the 1959 Life Insurance Company Income Tax Act. I need not repeat them here. My own studies and those of the General Accounting Office suggest that at times the marginal tax rate on investment income, as opposed to the average effective tax rate—a number that is more frequently quoted—has approached 100 percent.

Now, it is important to realize that the move to accelerated cost recovery, combined with the investment tax credit, was an attempt to try and move closer to expensing or first year writeoff, or the analog of consumption-tax treatment within the framework of a separate corporate tax. That was the good news of our 1981 Tax Act.

The bad news, as we all know, is we did not get it exactly right. TEFRA attempted to redress some of that, and perhaps we could not afford all of the good news.

So I continue to suggest that, rather that retreat from the movement toward single taxation of saving and toward implicit, if not explicit, integration of the corporate and personal tax, that we need to be very cautious in moving anything like back to the 1959 act first of all or, worse yet, trying to attribute some amount of the inside buildup to policyholders, add it to their tax base, and have it taxed at their marginal rates.

I think that would probably be a 180° turn from where tax policy is heading in order to achieve neutrality in our capital formation process, and I hope this committee will have that broader concept in mind simultaneously with the enormous number of detailed complications concerning the life insurance industry itself.

Let me just make one or two other points, as time is limited and you have been gracious enough to let me try to catch my plane.

First of all, if we are going to think about an integrated corporate and personal tax, clearly the shoe has been put, I think, on the wrong foot by arguing that we ought to have a differential favoring stocks, that is a tax penalty on mutuals. Ideally what we ought to be doing is integrating the corporate and personal tax and taking care of stock company dividends that way.

If we cannot, we heard testimony this morning concerning this issue of trying to attribute some equity ownership interest in a mutual company back to the policyholder or, alternatively, having some disallowance of dividend deductions at the corporate level, and I would just like to say a word or two about that since it is obviously a very important issue and one that you, Mr. Chairman, just raised again.

First of all, if one accepts this concept—and I do only in a very limited way—the issues of measurement are absolutely horrendous and extremely difficult. Let me give you an example.

We do not tax the imputed income to owner-occupied housing, for some of the same reasons, or to consumer durables. If the argument is that if we liquidated a mutual company that there would be something extra for the policyholders—in your example, we would sell off these paintings in the lobby and that would be divided on some pro rata basis among the mutual company's policy holders, the participating policyholders—we have to be aware of the fact that, while one can conceive of such an item, that any such claims, and whatever the legal issues involved, to an economist are enormously difficult to compare to other assets.

To compare it to stock, well, we cannot buy and sell this asset very easily on a market. It is not a very liquid asset. Mr. Aaron in his testimony and in his work has suggested taking the after-tax rate of return on municipal bonds because of the tax-exempt nature——

Chairman STARK. If I can interrupt there. It is not in the hands of the shareholder that I think we are trying to measure it. We can measure it in the hands of the corporation in terms of minimum dividend requirements or undue surplus accumulation. So it is strictly in the hands of the corporation and/or the mutual society that we look at this.

Mr. BOSKIN. OK, Mr. Chairman, and the question is how do we measure it. And what I am suggesting is, in trying to come up with a way to get an estimate, we resort to comparisons to other types of assets which have a variety of characteristics which are very different. For example, they are liquid and saleable in a way that we have some market prices we can use.

That makes it very difficult. Mr. Aaron suggested blowing up an after-tax long-term municipal bond rate and attributing it to surplus, and one problem with this is that at least a long-term municipal bond is traded frequently on markets and is liquid.

So I would suggest that, even if one were to try and go down this route, innumerable issues of measurement arise and innumerable issues of comparability arise; and any equivalent one could think of would certainly be an asset that had characteristics which were more favorable, that is, that you could buy and sell them freely and therefore would be worth more to the owners.

So I just suggest that while worthy of further study, I think that is an issue that has raised more questions than it has answered.

I appreciate the opportunity to go through a very brief summary of my testimony. My main conclusion is that we should not be reversing the good news in our tax system, which has been to try to remove the impediments to saving that our tax system had caused previously.

We ought to continue in that direction as we can afford to do so, given the state of the budget; the importance of the life insurance industry in long-term capital formation, the substantial investment they do in mortgages and long-term bonds, for example, suggests that raising taxes on or trying to attribute taxes to an inside buildup is probably the exact opposite of the direction we ought to be moving.

Thank you.

[The prepared statement follows:]

STATEMENT OF MICHAEL J. BOSKIN*

ISSUES IN THE TAX TREATMENT OF LIFE INSURANCE

I. Introduction

A. The Effect of Saving on the Economy

The substantial and sustained recent recession overlays a severe long-term slowdown in our rate of economic growth. This reduction (for example, from an average annual increase in labor productivity of 2 to 3 percent or more in the quarter century after World War II to a trivial fraction since then) has frightening long-term implications. Small differences in growth rates of per capita income among advanced economies are sufficient, when compounded over a long period of time, to alter drastically the relative standard of living of these societies. Put bluntly, if we do not return to something like our long-run historic growth rate, quite aside from the pace at which we recover from the recent recession, we shall see a future in which the standard of living of Americans is much below those of Western Europe and Japan.

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*/ Professor of Economics, Stanford University. This statement was prepared at the request of the Mutual Company Executive Committee. However, the views expressed herein are those of the author and not necessarily those of any organization with which he is associated.

What role does saving and its composition have in promoting or retarding our long-term growth? Does tax policy impact our rate of saving? Is tax policy a sensible concern for those wishing to do something to reverse our long-term growth slowdown or should we focus attention on monetary policy, investment policy, or overall fiscal policy?

While there are undoubtedly a variety of influences on saving behavior, both as to its level and its composition, tax policy is likely to play an important, but not exclusive, role in determining these crucial parameters; changes in our saving rate and its composition are likely to affect our long-term investment rate; this in turn will affect our long-term growth rate via the links between our investment rate and our rate of technological progress.

The U.S. saving rate is not only low, but has been falling when properly measured. Further, a variety of important shifts in the composition of that saving, especially toward financial instruments, which through financial intermediaries are invested in the shorter end of the market, have accelerated in recent years. Thus, our low and falling saving rate, and the dramatic changes in its composition, are a cause for major concern. This would be true quite aside from the problems we confront over the next few years, which have come to be called "structural deficits."

If structural deficits are a problem, they must be a problem because government dissaving or borrowing is soaking up badly needed funds which could be available for investment purposes (to the extent that government is not using the proceeds for equally productive government investment). Deficits on the order of 5 or 6 percent of Gross National Product (GNP) would not be alarming in a society which saved several times this amount, such as is the case in Japan and to a lesser extent, Western Europe. However, our own net private saving rate, inclusive of that generated by households and businesses, is estimated at about 7 percent of GNP. Thus, ignoring any short-term inflows of foreign capital, the government is likely to be dissaving a large fraction of what our society is providing in terms of net savings to augment our capital stock, which in turn is growing too slowly and aging too rapidly. My purpose here is not to discuss the extent to which structural deficits are a problem or how to deal with them. One important point does need to be made, however. That is simply this: among all of the painful choices that confront us concerning ways to reduce the deficits, the least desirable are those that involve a reduction in private saving. For example, any tax increases that hit private saving heavily would be in this sense counter-productive.

B. Taxes and Saving

In this context, it has been unfortunate that a variety of features of the taxation of life insurance companies, especially the Menge formula, interacted with rising and volatile nominal interest rates, which in turn were partly caused by accelerating but fluctuating inflation, to wreak havoc in the effective tax rates applied to that component of whole life insurance which can be thought of as a form of saving as opposed to term insurance. In particular, throughout the 1970s, the effective rate of taxation on life insurance saving increased substantially relative to the rise in the effective tax rate on saving broadly construed. This in turn was reflected in the substantial decline in the fraction of income saved in the form of whole life, a decline of about 60 percent over the last quarter century, which accelerated almost simultaneously with the rise in inflation in the late 1960s and 1970s.

The calculation of these effective tax rates is a nontrivial matter, and I do not wish to dwell on the technicalities here. Suffice it to say that my own calculations, as well as those of the General Accounting Office (GAO), indicate that as a result of the Menge formula, the marginal tax rates on life insurance company investment income at times approached 100 percent. This, obviously, substantially reduced the after-tax return available on this financial instrument and caused a shift into other financial vehicles, many of which were translated into short-term investment, and perhaps led to a decline in the overall net saving rate in our society (along with a variety of other economic and demographic causes).

Substantial changes in the corporate and personal tax treatment of saving and investment income have occurred in recent years. In part these are a response to the acceleration of inflation in the 1970s which wreaked havoc with the definition of taxable income (relying on historic cost depreciation, taxing nominal interest even when it was below the rate of inflation, etc.). Again, a full review of these episodes is beyond the purview of this Committee's Hearings. Suffice it to say that through the Accelerated Cost Recovery System as implemented in the Economic Recovery and Tax Act of 1981 and as amended by the Tax Equity and Fiscal Responsibility Act of 1982, the effective marginal tax rates on new investments of many types were reduced substantially. In fact, the original 1981 legislation actually created negative effective marginal tax rates on certain types of investment. Even with the attempt to eliminate this feature in the 1982 Act, for exmple by eliminating some of the unimplemented phase-in of ACRS, the combination of investment tax credits and capital cost recovery reduced substantially the effective marginal tax rate on invesment income. However, it still left us with widely varigated tax rates on different types of investment. For example, land and inventories were still more or less taxed at the statutory 46 percent rate, whereas in the original 1981 Act, somes types of capital, such as construction machinery, actually had a negative marginal tax rate. Thus, while the effective tax rates at the margin on a variety of corporations were declining substantially, life insurance company investment income was still subject to high and widely fluctuating effective marginal rates because of the use of Menge. Therefore, a stopgap was introduced, designed to give all parties concerned an opportunity to reevaluate the appropriate tax treatment of life insurance. It is this issue that I wish to address within the framework of a sensible overall tax system, both with respect to its structure and its equity.

C. The Nature of Our Tax System

Before doing so, let us repeat that our current system of corporate and personal income taxation is not really a system that taxes income, but a hybrid of what might be called a consumption tax and an income tax. An income tax taxes saving twice, first when it is earned as part of income and again when it earns a return in the form of interest or other return.

Among the most important changes in personal taxation in recent years has been the extension of a variety of types of tax free saving vehicles (most notably the universal Individual Retirement Account (IRA) which was introduced in 1981). Such a system, which allows people to deduct their investment in such an account, accumulate interest tax free, and then pay tax at withdrawal when the proceeds are consumed, allows people a form of neutrality in the consumption/saving choice which an income tax does not. Under an income tax, there is a bias toward spending today, since the return to saving is reduced by the tax; a consumption type tax, such as we are moving toward with IRA acounts and other similar features, is neutral with respect to when over their lifetime individuals consume their potential purchasing power.

Historically, the "inside build-up" in the non-term part of whole life insurance was taxed in a manner similar to this IRA-type consumption tax treatment. Housing, another long-term investment, is treated similarly. Further, Social Security was not even taxed at withdrawal, and only now are we in the process of implementing a taxation of half of Social Security benefits (including an analogue of an inside build-up) for the wealthiest retirees. The widespread concern for the generation of long-term risk-taking capital has also led to a variety of reductions in the effective tax rates on capital gains in recent years, both through rate reductions in personal tax and a reduction in the fraction of long-term capital gains includable in taxable income. The effective rate on capital gains is probably on the order of 5 to 10 percent on average, once one takes into account the advantages of deferral.

Thus, in considering the appropriate tax treatment of life insurance, a variety of issues come to the fore: what is the nature of whole life insurance? To what extent should it be thought of as one of our society's portfolio of long-term saving vehicles? How is this taxed relative to other types of saving? Is any particular system of taxation at the company level actually violating simple and basic norms of tax policy, and how can these be redressed? In the context of our current severe structural deficit problems, can we move to what most of us have long considered the ideal tax structure -- an integrated corporate and personal tax on consumption in which corporate source income would be attributed back to shareholders who would be allowed to deduct all of their net saving and investment from a comprehensive measure of income to arrive at their spending, which would be taxed at the personal level (rather than as a sales tax or value-added)?

While it will be a long time before we are able to restructure our tax system to approximate this ideal, it is crucial that any attempt to reform the tax treatment of a major component of our potential flow of saving be consistent with a move in a sensible direction rather than a retreat or retrogression from the recognition of the desirability of neutrality in the consumption/saving choice as reflected in the tax reforms mentioned above.

II. Issues in Reform of the Taxation of Life Insurance

A. Ideal Taxation of Life Insurance

With these general principles and considerations in mind, where do we go from here? Were there no political, deficit, or other constraints to move toward an integrated corporate and personal consumption tax, the inside build-up in life insurance should not be taxed at all. It can be thought of as saving on the part of policyholders done through the intermediary of a life insurance company. Thus, including any portion of it in the taxable income of policyholders would be incompatible with a consumption tax treatment of saving.

B. Constraints on Ideal

Some people argue that moving to such a tax treatment in general, including life insurance, is not possible given current revenue and other constraints. My response is that it is therefore necessary that any change in the tax treatment of life insurance inside build-up be compatible with a move in the direction of the ideal tax that we ultimately want to have. A variety of alternatives have been suggested: a proxy tax, changes in the deductibility of dividends, attempting to disentangle underwriting and investment income, and a variety of other conceptual approaches. Also, continuation of the current stopgap is viewed as a second or third-best compromise by many people.

Attributing gross investment income less expenses less perhaps the historical 3 percent of reserves would be a substantial move away from both the traditional tax free nature of the inside build-up and the consumption tax norm or ideal. The taxation of life insurance is conceptually so complex that a variety of people have made proposals to adjust one or another of the particular features of the law. It first must be pointed out that the desirable base against which to levy taxes is conceptually not independent of the structure of rates and the unit (and time period for that matter) of account used. A substantial tax base with very low rates is an alternative to a narrow base and much higher rates; in general, if there were substantial reasons to exclude items in a tax base, it is better to have it as comprehensive as possible with very low rates to minimize the distortions in eonomic activity that occur because of high tax rates in one versus another activity.

C. Life Insurance Taxation and the Current System

Where does life insurance then fit, with its inside build-up, in a spectrum of types of saving? Is it very much like housing and retirement programs, or very similar to other instruments of a short time horizon part of the market?

It is my own belief, first, that all savings should be taxed only once. Our current system of doing this for some types of saving and not others is irrational, inefficient and inequitable. Thus, my ideal tax norm would treat many of the short-term type financial investment vehicles in the same manner as housing and retirement programs. I do not believe that it makes sense to attempt to enumerate the ostensibly noble goals of saving, but rather to rely on individuals to do this themselves. However, as we are progressing toward this ideal, it is important to note some important features of whole life insurance. First, most life insurance is of a long-term quasi-contractual nature. It does not make much economic sense for people to buy front-end cost loaded products for short-term purposes. Second, life insurance companies mainly invest in long-term corporate bonds and mortgages, or at least have done so historically. Third, life insurance is widely used as a saving vehicle as well as a term insurance vehicle by the middle class, particularly the young and middle aged individuals and families. Thus, if a practical set of considerations forces us to attempt to distinguish among different types of saving vehicles, life insurance would tend to be at the longer-term end of the market, close to Social Security, retirement plans, and housing. This is important if one is attempting to arrive at any specific set of practical recommendations for comparing alternative rate and base structures.

If one were attempting to estimate the true income earned by policyholders in a whole life contract, one ought to look at the cash surrender value, plus dividends received minus payments made. This would be a reflection of the net increase in the wealth of a policyholder. Actually, an adjustment might be made for the consumption cost of purchasing the term insurance component of a whole life policy. Thus, if one has to think of the base and rate separately, the ideal or norm would be the integrated corporate and personal consumption tax, and there would be no tax at all on the inside build-up of life insurance. However, if for political and practical reasons some compromise must be reached, an attempt to measure the income attributable to policyholders would be reflected as above, and the appropriate tax rate, conceptually zero in an ideal tax, probably ought not to exceed that on comparable assets. In an ideal consumption tax, the rate would be zero. Premiums would be deducted and proceeds would be included in income to the extent that they were not eventually reinvested. Social Security, housing, and retirement programs are also taxed at a zero level (actually, Social Security at a negative rate) if one wanted to make comparisons to similar saving vehicles.

If one wanted to look at the marginal tax on new invested capital, that rate would approximate 10 percent before adjustment for ERTA and TEFRA. This rate is much lower than the statutory rate of 46 percent because of a variety of adjustments such as the Investment Tax Credit and various types of depreciation and other allowances. The rates were actually reduced substantially in ERTA (as mentioned above, often to negative rates) and raised partly back to their original levels by TEFRA. The stated intent of TEFRA was to make the combination of the investment credit and ACRS no more generous than expensing of investment. Expensing of investment, or first-year write-off, is the treatment in the corporate tax framework that is consistent with a consumption tax. That is, full deductibility of investment at the time made, rather than gradual depreciation. Relative to a consumption tax, so-called accelerated depreciation, was decelerated depreciation usually, and parenthetically, relative to the consumption tax norm the so-called tax expenditure of $6 billion estimated by Treasury and CBO because of the tax free inside build-up in life insurance is really not a "tax expenditure" at all, but the appropriate tax treatment relative to a consumption tax.

Other comparisons are also possible. For example, the increase in the cash surrender value accruing over a span of time has certain similarities to long-run capital gains. These are taxed at a maximum rate of 20 percent (40 percent includable in taxable income times the 50 percent maximum marginal tax rate), and at an average effective rate considerably less than this once one accounts for the fact that much capital gains are received by people below the maximum rate, and capital gains are taxed on realization (except at death) rather than on an accrual basis. Perhaps an appropriate effective tax rate on capital gains would be 8 or 10 percent.

In my opinion, it would be an enormous step backward to tax the inside build-up component, however well or poorly measured, at the marginal tax rates of typical taxpayers (which average about 24 percent). This would result not only in a reversal of the historic conceptual treatment of the inside build-up, but in a 180 degree policy change from the intent of the last few tax reform acts, such as those in 1978 reducing the effective tax rate on capital gains, the universality of IRA accounts in 1981, the changes embodied in the stopgap in TEFRA, and the current state of ACRS.

Another thorny issue arises because of the payment of dividends. In an ideal integrated corporate and personal consumption tax, households which reinvested their dividends would not be taxed on them at all. Further, to the extent that they were consumed, taxes wuld be paid only once, at the personal, not the corporate level. Therefore, dividends would be fully deductible. Since we do not allow complete dividend deductibility -- although we do have a dividend exclusion which is used by a substantial fraction of the life insurance dividend receiving population -- we are far from the integrated tax norm. Some might argue that there is an easily definable, and conceptually correct, "equity" ownership in a mutual company. In my opinion, the issue is not nearly so straightforward as this. Whatever equity policyholders might have in a mutual company is surely quite different from whatever equity they might have as embodied in common stock ownership. The marketability, measureability, market price information, etc., are all substantially different if not totally incomparable.

Since the ideal treatment would allow full deductibility for dividends of all types in an integrated corporate and personal income tax, it may not be worth the candle to attempt to define and measure something so complicated when hopefully we will be able to phase out the double taxation of dividends in our tax system over the next few years.

III. Summary

I have covered a variety of issues from the importance of saving and its composition in our society, to the varying rates of taxes on different types of saving, to the ideal integrated corporate and personal tax norm. My major points can be summarized as follows:

1. Structural tax reforms, even in the context of our severe structural deficit problem, should be made in such a way as to move us at least partially toward our ultimate goal of an ideal tax system. This is an integrated corporate and personal consumption tax as a first approximation, and we should not be making tax reforms which move in the opposite direction.

2. The structural ideal may not be achievable quickly because of structural deficits and other problems. In that case, the appropriate consideration to give to these alternative concerns suggest very strongly that we not attempt to redress enormous government dissaving by worsening the incentives for private saving, especially private saving of a long-term nature.

3. Our current tax system is something of a hybrid of an income and a consumption tax, and we have been moving more toward the latter through time. This is a healthy development on both efficiency and equity grounds. Moving further in this direction as possible given revenue needs and spending demands is desirable. Saving should be taxed only once, not twice; corporate source income should only be taxed once, not twice.

4. These principles should be applied (unless there are unusually persuasive exceptions) in a neutral manner across all industries, investments, etc. We should not just be singling out certain types of financial investments for certain types

of treatment, but be moving toward a system where all reinvested income is not taxed until it is withdrawn for consumption purposes.

5. Historically, the tax treatment of the inside buildup in life insurance approximated a consumption tax norm. However, a variety of technical features of the Life Insurance Company Income Tax Act of 1959, interacting with high and fluctuating nominal interest rates, led to a gigantic increase in the effective marginal tax rates on the investment income. This in turn dramatically reduced the after-tax real rate of return available on life insurance, even relative to the general decline in the after-tax real rate of return in the economy in the 1970s.

6. Our low and misallocated saving rates are a substantial cause for concern both with respect to supporting badly needed investment in the recovery and, as important, supplying domestically generated capital for long-term capital formation, technological innovation and growth.

7. If we cannot move to the ideal tax system where we tax corporate and personal income on an integrated basis (only once) and remove the remaining double taxation of saving, piecemeal reform ought to proceed at least in the general direction of this ideal to the extent possible.

8. Thus, while a variety of proposals have been made for reform of life insurance company income taxation, includ-

ing development of a proxy tax for policyholders' inside build-up, extreme caution must be taken in defining what the effective tax rate will be on the saving component of whole life insurance. Ideally, it like all other tax rates on saving ought to be zero in the consumption ideal. If this is impractical, a retrogression from the dramatic improvements that have been made in some ways (making IRA accounts universal, reducing the effective marginal tax rates on capital gains, etc.) should be resisted. We should improve our incentives to save and to allocate saving among competing uses efficiently (rather than providing varigated tax rates); the effective rates ought to be kept as low as possible. When compared to other long-term type investments, such as housing, retirement plans, and Social Security, the rate would be approximately zero. Further, the effective tax rate on long-term capital gains is perhaps 10 percent or less, and the average effective tax rate at the margin on investment capital is no higher than 10 percent and is approaching zero due to the recent series of tax reforms. The worst possible solutions of those being discussed would be to attempt to determine some policyholders' income attributed back to the individual and tax it at their marginal tax rate by including it or most of it in their taxable income. This would be the exact reverse of the most important structual changes we have made in the tax system and move us back toward double taxation of saving, since most life insurance is purchased out of after-tax dollars.

9. If an attempt is made to try to measure the income of the policyholder, the appropriate concept of income is the change in net worth plus consumption. This would lead to an approximation of the cash surrender value increase plus dividends paid less premiums (but perhaps include a consumption cost of the pure term insurance component).

10. Let me reiterate that these issues reflect both historical and intellectual trends in determining an appropriate tax system for saving, both of life insurance inside build-up and other types of saving vehicles as well.

Chairman STARK. Thank you. I am sure that we may have some questions later, but I would say that if you want to be at Dulles by 5:30 you had better run to make it. We thank you for your testimony.

Mr. BOSKIN. I greatly appreciate that.

Chairman STARK. Mr. Duncan was going to inquire, but——

Mr. BOSKIN. I would be happy to respond to any questions.

Chairman STARK. I will pass now to Mr. Moore. Would you like to inquire? You pass for now? Of the whole mutual panel?

Mr. GUARINI. I just have one question for Mr. Boskin.

Chairman STARK. Would the gentleman yield?

Mr. MOORE. If it does not come out of my time, I would be happy to.

Mr. GUARINI. I know you are in a hurry, but you mentioned the Japanese, and of course they have a great deal more in savings and capital formation than we do. Do they put great emphasis on insurance in the same sense that we do?

Do our figures, when we say we are low on savings and capital formation moneys in our banks, include the amount of insurance companies? We hear figures of some 27-odd percent by the Japanese, and the Germans maybe 17 percent, and Americans only save perhaps 4 percent.

Could you comment on that, please?

Mr. BOSKIN. Yes; I think there are three points I would like to make briefly:

One is that the Japanese rely much more heavily on private insurance mechanisms, both explicit and implicit, and much less heavily on social security kinds of government-provided insurance mechanisms than do we. A very large fraction—it was quoted to me by a Ministry of Finance official in Japan—almost 70 percent of elderly Japanese live with their children, for example. It is obviously a much lower fraction here.

Their social insurance programs are, depending on the phrase you would like to use, either much less well developed or poorly developed.

Mr. **Guarini**. More specifically, if this country saves only about 4 percent and the people put away a certain amount of money in savings accounts, does that figure include the kind of moneys that they put away in insurance which is also savings and also capital formation?

Mr. **Boskin**. If we add up pensions, saving done on behalf of individuals by businesses in retained earnings, and the traditional kinds of household savings like a passbook account and things of that sort, net of depreciation, that figure is around 7 percent for the United States. It has averaged that in recent years.

That figure is approximately one-half the corresponding figure for Western Europe and a little less than that relative to the Japanese.

Chairman **Stark**. What happens if you add in homeowner-occupied equity in housing?

Mr. **Boskin**. The differentials remain, but they are reduced some. We have a better housed population than the Japanese. They have small houses and sleep on tatami mats.

Mr. **Guarini**. Is the Japanese high savings rate due to the tax treatment that they give their savings accounts or the tax breaks they give?

Mr. **Boskin**. As near as we can tell, there are several reasons, one of which is that a very large—there are many more tax-exempt vehicles and they are much more generous in terms of the amounts—there are these incentives, the postal savings system, et cetera.

It is also true in a variety of Western European countries, and I think if one drew a spectrum we would be toward the bottom in terms of our movement toward single tax rather than double tax on savings.

Mr. **Guarini**. They would be inclined to repeal the 10-percent withholding tax?

Mr. **Boskin**. That is not an issue I can give a sensible response to at this stage, sir.

Chairman **Stark**. Mr. Moore?

Mr. **Moore**. Thank you, Mr. Chairman.

Dr. Boskin, it is good to have you back before the committee.

I remind my colleagues that it was Dr. Boskin who did the econometric model that was used to promote and convince the committee and the administration to go along with the changes that were made in 1981 for individual retirement accounts. Dr. Boskin's study was very, very crucial to us.

I think he would say today that, if we were having a hearing on that, that we need to now allow nondeductible contributions to IRA's to expand it further. With a nod of his head, let the record so show, and we will get into that later. [Laughter.]

Dr. Boskin, I read your testimony with great interest, because I am a believer in your theories. I want to be sure we understand you straight. What you are telling us is that anything we do to tax life insurance companies, be sure we are not damaging long-term savings, and that that is a value that life insurance companies are providing to us.

Mr. **Boskin**. Right.

Mr. **Moore**. We certainly do not want to do that. We also have to be careful not to create something that treats savings in life insurance contracts differently than other forms of savings. I think your advice would be, treat the rest of them like you are treating life insurance, rather than treating life insurance like you treat the rest of them; am I right?

Mr. **Boskin**. I think that is exactly correct. If we took life insurance and taxed it like ordinary passbook interest, I think that would be extremely damaging, in the same way as if we tried to impute the savings embodied in owner-occupied housing.

As I mentioned in my written testimony, we ought to tax all savings vehicles only once.

Mr. **Moore**. As consumption. I wanted to be sure I understood that.

Thank you.

Mr. Chairman, now I have some questions that I would like to ask the mutual company panelists, and I want to thank all of these distinguished gentlemen for being here, in particular Mr. Purvis from my home State. I am glad to see him here. He represents the only mutual company, I think, in Louisiana.

I do not mean that in an ominous way. [Laughter.]

Mr. **Purvis**. We have been outnumbered for a long time, Mr. Congressman.

Mr. **Moore**. That is a mark of distinction. This morning we heard testimony by Secretary Chapoton suggesting changes in the law, and then we heard to a limited extent the General Accounting Office come forward with additional suggestions, some being the same.

I would like the panel to respond briefly as to whether you agree or disagree. Specifically, I would like the panel to answer a few questions that I will also ask the stock companies tomorrow.

My first question concerns your position on the suggestion by Secretary Chapoton that we modify the loan and withdrawal rules affecting policyholders to make life insurance loans taxed more in line with the rules we passed last year for retirement plan loans. We tightened them up, if you remember.

Mr. **Van Fossan**. The specific issue, Congressman—it is a dual question, as you are aware. The specific issue of the last-in, last-out, capital-in, capital-out, interest-in, interest-out, which was addressed in TEFRA, has not been discussed heretofore as it relates to life insurance. I would not attempt to speak for the mutual companies, other than to say I think the area should be looked at and it is certainly one that is open for deliberation as to whether or not there is any reason to have significant differences.

But I do not have an opinion on that issue today.

Mr. **Moore**. The modification of the withdrawal rules is part of that same question. I think the answer would be the same.

Mr. **Van Fossan**. Would any of my colleagues have a differing viewpoint?

Mr. **Creedon**. As Mr. Van Fossan said, this is a completely new concept as far as we are concerned. It has not been raised with the stocks or the mutuals heretofore. My own reaction offhand would be that it would be a very significant change in the nature of the life insurance policy and the basis on which it has heretofore been sold, and especially to people of moderate circumstances.

I think, as Mr. Purvis mentioned, the average life insurance policy in force is a relatively small policy, and it is owned by people of relatively moderate circumstances. In the case of Metropolitan, for example, the average life insurance policy is $5,500. That is the face amount, so the cash surrender value is significantly less.

And these policies are sold in part with a recognition that people can borrow on them and then pay it back from time to time.

Now, I do not know exactly what Mr. Chapoton had in mind with respect to a loan like that, whether he would tax an individual of moderate circumstances. I think we would have to look closer, but it would be a significant change in the nature of the contract, and how people have viewed it, and how we have sold it. And so I would think we would have to really give it hard study.

Mr. **Van Fossan**. Did you have a comment, Jim?

Mr. **Martin**. Just one further observation on that. I will not echo what has been said by the others, but as we look at anything like this, we also examine the difficulty or the impossibility of administering something of that nature.

If the policyholder has an asset against which he can borrow, he does not have to borrow it from the life insurance company. If the value is there, he can borrow it from the bank. Thus, it could very well negate what might be attempted through changing the rules applicable to policyholder loans.

Mr. **Moore**. The second point that Mr. Chapoton raised this morning, the elimination of the third-phase deferral for stock companies. I rather imagine I know the answer to that, but let us get it on the record anyway.

Mr. **Van Fossan**. I am going to ask Coleman Bloomfield to comment on that if he would.

Mr. **Bloomfield**. I am not sure that I could add anything more to that subject, except that there is this $9 billion item of income that apparently has not been taxed, and I think that should be examined in the review of the whole question of life insurance taxes.

Mr. **Van Fossan**. I might, if I could, add, Congressman, as one who has spent 24 years in a stockholder-owned life insurance company prior to my last 12 years in a mutual life insurance company, that there are in fact discriminating areas relating to the phase system, and in my judgment until we clean those up, there is no way to have a viable tax law that creates a level playing field.

Mr. **Creedon**. I think too, certainly prospectively, we feel that the three-phase system should be eliminated. We are in favor of a single phase tax based on economic income.

Now, as far as the $9 billion is concerned, that is a complication that the subcommittee has to deal with.

Mr. **Moore**. The third point the Secretary brought up this morning was the modification of reserve deductions to provide for an actual reserve deduction rather than the 818(c)(2) estimated reserves that we use now. I think I heard or read that covered in one of the statements, but let us get it on the record to be sure that that is the case.

Mr. **Gerken**. I think in my comment on economic income, I said it is our position as mutual companies to give up the 818(c)(2) deduction.

Mr. **Moore**. Would you repeat it a little louder, sir? I am not sure that the reporter could hear you.

Mr. **Gerken**. It is the position of the mutual companies in our proposal that we would give up the 818(c)(2) provision as a method of valuation.

Mr. **Creedon**. I think it is important to emphasize in connection with giving it up, a point that was made I guess when Dick Minck was on, and that is that the 818(c) deduction does benefit presently both stock and mutual companies. But we feel as part of a single-phase system that it has to go.

Mr. **Martin**. May I make one further comment on that, though. Not to disagree with the others, but this is the device that is used by both large and small companies as well. But if it were wiped out and if nothing were done in addition, it would leave the small companies in an untenable position, and we would stress something would have to be done to address that.

There are a variety of very simple ways of getting it done. But we do not recommend just wiping that out, period, and then forget the small companies.

Mr. **Moore**. Another point raised by the Secretary is to establish a statutory definition of life insurance. This gets at the issue of what is really life insurance and what is really a new technique for selling money markets or whatever, with a little bit of life insurance tacked on.

Mr. **Van Fossan**. We heartily concur, Congressman. And as was stated in two or three different aspects of our testimony, we wholeheartedly support that. We have had a technical group from the mutual companies of our senior tax and actuarial people addressing that issue, following some earlier dialog with the committee.

I delivered today to staff a definition of life insurance that we feel serves as a starting point for the consideration of the subcommittee. We are also submitting a copy of that first thing tomorrow morning to Secretary Chapoton.

Mr. **Moore**. Last thing, Mr. Chairman. I appreciate the Chair's indulgence.

The Chair raised the point about treating a portion of the mutual policyholders' dividends or returns as return on equity and taxable. I would like to ask you to take the comments one step further.

In connection with this, should we be analyzing the total tax burden of the stock companies vis a vis the mutual companies? If we do that, being sure to create a level playing field, should we include in the stock companies' portion of taxes paid, the taxes that their stockholders are actually paying on the dividends they receive?

According to staff, that represents in 1981 a substantial amount of money, about $1.5 billion. So essentially, should we take that $1.5 billion in account as being paid by the stock side of the ledger in trying to create a tax system that will see to it that mutuals and the stocks are paying the same thing?

Mr. Bloomfield. This is a point which I made in my testimony, and that is that the policyholder pays a tax, in effect, as he contributes his alleged capital into the mutual company. And any contributions that the mutual policyholder pays toward equity is really taxed at a 46-percent rate, and that really involves paying a tax, that portion of the tax, in advance and puts the mutual policyholder really on all fours with the shareholder in the stock company.

Mr. Moore. So your idea would be that, you should not take that into consideration, the amount of taxes that the shareholders of stock companies pay.

Mr. Bloomfield. That is correct.

Mr. Moore. By the way, I misspoke. It is $1.5 billion in dividends, not taxes.

Chairman Stark. Would you yield?

Mr. Moore. Certainly.

Chairman Stark. I do not know how that washes in practice. In theory it may work, but basically you all, the mutuals as a group, only pay, for the most part pay your taxes on investment income. Premium income really goes into the other phase, where you are not paying much in the way of taxes.

And as a practical matter, are we taxing that? Is that a fair statement, to say that there is a difference?

Mr. Bloomfield. Mr. Chairman, the suggestion that we make as mutual companies is that our tax be based on total economic income without regard to whether the source is investment income or premium income or any other source.

Mr. Groom. Mr. Moore, I was just going to add a couple of additional comments with respect to your question. We make sort of separate points with respect to the differential point at the corporate level and at the policyholder level:

As has been said here several times, we think that there is equal treatment at the corporate level, even if we get 100 percent dividend deductibility, by virtue of the fact that the contributions to our capital in the form of premium are taxed at the corporate level, while contributions to capital of stock corporations are not.

Now, your question, however, as I understand it, does not address that, but really addresses the comparison at the individual shareholder level, and when you make that kind of comparison you have to look at a number of factors. Many of the shareholders of stock corporations are tax-exempt entities and do not pay any taxes.

The shareholders of stock corporations are also probably quite different people than the people who are mutual company policyholders. We would guess that a very large percentage of the policyholders, if they did receive some imputed dividend, would have that dividend excluded by virtue of the $200 dividend exclusion of existing law. So even if we made a computation for mutual policyholders in some role as equity owners, our computation would indicate that there would be very little tax due there.

So we think basically there are just very different situations at the individual shareholder level.

Mr. Moore. I do not disagree with your points. If we are going to try to create a tax bill that takes *x* amount of dollars or will take *x* amount of dollars out of the life insurance companies, the bill should not take more out of a stock company than it does a mutual.

To prepare such a bill you must know who is paying the taxes. In the case of a mutual, the shareholder is not. In the case of a stock company, the shareholder is.

It sounds like an oversimplification, but I understand the point about the capital contributions in the beginning. That would be taken into account on the mutual side of the ledger. I am just wondering if we should not consider as part of the total economic package of taxes being paid by the life insurance industry the taxes paid by the shareholders.

Mr. **Groom**. Dr. Boskin was further suggesting to you that the way to approach this problem is not to move in the wrong direction, away from integration, but to move in the direction that you should ultimately want to go toward integration and possibly to do that by taking a step in the insurance area, where you have investment income and where you have this unique situation of mutuals and stocks.

But if you want to address the problem that you are concerned about, that some form of relief on the integration side, on the stock side, might be an appropriate way.

Mr. **Moore**. I fully agree with that, but unfortunately that is not under the jurisdiction of the subcommittee, and I do not think there is a consensus of opinion on the full committee that we should stop the double taxation of dividends. I readily agree with that and would support that.

But absent that, if we are going to create a level playing field, then we have to consider seeing to it that everybody who gets dividends is taxed, rather than exempting some and taxing others. That seems to be the question.

Mr. **Zinn**. Mr. Moore, I think that in order to refine the figure for dividends down and determine what the taxes are, you would have to analyze who holds the stock of stock life insurance companies. Mr. Groom has already mentioned that some of that stock may be owned by exempt organizations.

A lot of that stock undoubtedly is owned by other corporations that are entitled to receive either the 85 percent or the 100 percent dividends received deduction. Some other stock may be owned by individuals who are entitled to the $200 exclusion.

I think all we are saying is that what may appear to be a very large figure to take into account, if you are going to take it into account on that side of the ledger, may turn out on analysis not to be as material as would first appear.

Mr. **Moore**. I appreciate your comments. I do not disagree with that at all. I am talking about the equity of it or how we should take this into account, not the amount.

I suspect you are right, the amount of taxes paid on that $1.5 billion in dividends is probably rather low. My point is, should we consider it. Let us talk about that from a conceptual point of view, not from a quantum point of view.

Mr. Chairman, thank you very much for the time.

Chairman **Stark**. Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

I wanted to ask a question in regard to reserves. I believe your proposal suggests that we use State-required reserve levels, essentially, and some people think that that might—well, those are very conservative estimates in many cases.

And while I have no objections to being conservative, it seems that that might give the possibility of overstating reserves and understating taxable income. If you were filing with the SEC, you would probably be required to restate those reserves by some method, and I was wondering if you could give us any recommendation for dealing with that possibility of, how do you correctly state reserves or more accurately state reserves?

Mr. **Van Fossan**. If I could first, Mr. Flippo, make a general observation. We have had some discussions both with the staff and some members of the committee on this extremely complex issue. There is no question that relying on the individual States poses some problems because of the differences in the States.

At the same time, one of the more complex issues in life insurance is in being certain that the reserves are adequate on out into the future. Let alone forecasting 5 years or 10 years, as was noted in Mr. Martin's comments, you are forecasting 60 and 70 and 80 years.

We think rightfully we have historically in our companies taken a more conservative approach to the interest assumptions on the reserves, not from the standpoint of avoiding Federal income tax, but from the standpoint of being certain that we had adequate resources to pay the claims and the maturities of those contracts when they matured some 40 or 50 years out.

Having said that, we did, in the definition of life insurance that we have submitted to the staff today and will submit to the Treasury tomorrow, address the issue of identifying appropriate level of reserves as a significant part of defining what qualifies as life insurance.

Mr. **Flippo**. So you have made the recommendation?

Mr. **Van Fossan**. Yes; we have.

Mr. **Flippo**. Thank you, Mr. Chairman. Thank you very much.

I would be interested in seeing what those are at a later time. Perhaps we can discuss that.

Mr. **Guarini** [presiding]. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I am interested in the concept of the so-called level playing field, and of course what looks level to you depends on the angle you are looking from. We have all made new acquaintances in the insurance industry on this committee recently. We have had a lot of visitors from a lot of different segments of your industry, and the visits that we have had have been very instructive.

It is kind of an interesting situation, in which the industry is divided into stocks and mutuals and different approaches affect the different segments of the industry in a radically different manner, and that is what makes this so difficult.

In order to try to determine what the correct approach might be, I have been trying to analyze the effective tax rate on the real income of the mutuals versus the stocks. When you start talking about real income, the question is: Is it book income, is it income on your annual statement, is it some sort of concept of real economic income?

I, for the life of me, have not been able to take the cloak off of that question and find out what is the effective tax rate that your company has paid in the aggregate versus the effective tax rate that the stocks paid. Can any of you shed any light on that subject for me?

Mr. Van Fossan. I might open and then defer to my colleagues if I could, Mr. Dorgan.

In the formal testimony, not our synopsized version here but the total testimony, on the last page you will find an exhibit referring to three life insurance companies, all with the same economic income of $20 million. You will also see the classic illustration of the phase system resulting in an 82-percent rate for one of the life insurance companies, a 40-some percent rate for another company, B, and then a 22-percent rate for company C.

I do not know that there is any better illustration of the vagaries of the phase system relating to the same economic factors than that illustration.

I would comment for my own company, as recently as the late 1970's we paid as high as 94 percent of our net gain from operations to the Federal Government for Federal income tax. This past year under the stopgap provisions, my company paid $8,136,000 on a net gain from operations of $20 million; basically a 40-percent effective tax rate.

Mr. Gerken. I would like to add, if I may, that in 1980—to show you how absurd the phase system is—my company reported a $13 million loss from operations while paying the Federal Government $11 million in Federal income taxes.

Mr. Creedon. I think in a recent review of the companies that are listed in Best, there are about 1,200-some odd companies listed in Best, some 450 companies paid no Federal income tax at all; about 550 paid a Federal income tax below 30 percent of their net gain from operations; the balance of that number, 200-some odd companies, would have been paying above the 30 percent number.

And a great deal depends on the particular phase that the company is in and a whole series of complexities—this is one of the difficulties with the 1959 act and the portion of it that still remains in stopgap.

Mr. Dorgan. The numbers that you were citing were numbers after distribution of dividends, I assume?

Mr. Van Fossan. Those were after distribution of dividends, that is right, Mr. Dorgan.

Mr. Dorgan. That is one of the areas where the stocks and the mutuals divide on the question of how insurance companies ought to be taxed.

Let me ask you to respond generally to a question: The stocks would allege that the ability of a mutual to develop tax structure or have a tax structure imposed upon them that is based on economic income, that allows them to reduce their taxable income dramatically through dividends to policyholders, would not create a level playing field.

That would be what a stock company, I would guess, would testify to tomorrow. How do you respond to that?

Mr. Van Fossan. I would respond with the illustration, as I said to Chairman Stark in the conversation a while back. In my own company in designing a product—and we own a wholly-owned stock insurance subsidiary—had I placed the product in a mutual company the tax was significant. With full awareness, I could place the product in my wholly-owned stock subsidiary and understand I would pay no Federal income tax for as many as 20 years.

Mr. Creedon. I might illustrate a problem by using a particular product, which is, let's say, the universal life type product. For illustration purposes, let us assume that the contract requires payment of 3 percent, but the company can pay something over and above the 3 percent.

Now, let us assume that a stock life insurance company writes such a contract, makes 10 percent over and above the 3 percent, which it credits to the policyholder. So in effect the policyholder would get 13 percent credited on the side fund in the universal life contract.

What the stock companies say is that if a mutual company wrote that contract, of the 10 percent excess interest that is to be credited, we should pay 38 percent in taxes, and so we would only be able to credit 6.2 or 7.2, 6.2, whatever it comes out to. We do not think that is a level playing field. We do not think it is product equality.

Similarly, if you compare such a universal life type contract with an ordinary life insurance policy, not a universal life, written by a mutual company, they would have the dividend, which is comparable to the excess interest in the universal life type contract, taxed at 38 percent of some figure. It is just not a level playing field.

Mr. Dorgan. In your opinion, does the general proposal as outlined by Buck Chapoton this morning represent a level playing field?

Mr. Creedon. Well, I think we would have to understand more about Mr. Chapoton's view about the stock-mutual differential. I do not know whether you were here when Mr. Bloomfield commented on our view about the stock-mutual differential, but essentially we take the position that when a premium is paid in by a mutual policyholder, and part of that premium is analogous, as the stocks are saying, to an investment in the company, to an ownership interest in the company, that premium comes into our income stream and gets taxed at 46 percent.

When a comparable amount is contributed to a stock company, it is capital, it is not taxed at all. So the reason for an ownership differential is not apparent to us.

Now, maybe it needs a lot more study and maybe someone can convince us that what we are saying is not correct. But at least our understanding of what is happening does not support an ownership differential. If Mr. Chapoton has determined a method by which there should be a differential, I think we are prepared to look at it.

Mr. Martin. And I would say that except for that area that Mr. Creedon pointed out, in general, it does have the basis that I think we could find that would make a level playing field.

May I address further, because I have heard, as you have, apparently, ad nauseum also the complaint and the worry about life insurance companies paying out so many dividends that they will not have to pay any taxes. A simple way to respond to it is this.

These are fundamentally premium refunds, but no matter what you call them, they are cash that we have to write checks for or have to send the money out for. Then the stocks respond to us, oh, yes, but if you do not have it there, you could take it out of your surplus. That is not a bottomless well. The surplus of mutual life insurance companies as a group has been rapidly shrinking during the past several years, and it just is not there to distribute.

I might say parenthetically when we were trying to negotiate a unified industry position, we offered the stocks a means to protect against that—some sort of a minimum tax if that would make them feel better—but they would not accept that.

Just one additional comment. I think you will hear testimony tomorrow that if the mutual companies can deduct dividends that is going to drive the stock companies out of business, et cetera. Back in 1959, the effective deduction with respect to mutual companies was 90 percent. In other words, we got a deduction for 90 percent of our dividends. Stock companies were not driven out of business.

In fact, the contrary has happened. During the intervening period, stock companies have written a much larger percentage of the business, and our percentages of the assets in the business and of insurance in force have gone steadily down, and we believe because the tax laws unfairly discriminate against the mutual companies.

Mr. VAN FOSSAN. If I could, Mr. Dorgan, also, in responding to one facet of your question, go back to a question that the chairman asked of the prior panel.

The chairman raised the dilemma of why the premiums in life insurance industry went up last year and the tax revenues went down, and that indeed is a perplexing dilemma to the uninitiated. I would suggest to you, however, the answer does not lie in analysis of the taxes nearly so much as in analysis of where the premiums came from, and I would suggest three possible areas to pursue. One is the substantial and significant increase in group health insurance premiums that have occurred over the past 2 years due to the rapidly escalating health insurance costs in this country.

In my own company's case, our group health insurance premiums last year increased 29 percent. The losses, however, incurred by the major writers of group health insurance wiped out in almost all cases the gains from the added premiums.

The second area to pursue relates to the significant rise in deferred annuity premiums in the preceding 3 years. I have not seen the figures for 1982, but in 1981, according to the Conning Co. report, 9 stock life insurance companies received 51 percent of the total new premiums in the individual life insurance business, and that was primarily written on single premium deferred annuities.

Third, I would suggest to the committee, and we would be happy to provide a copy of the statistical report of the Life Insurance Marketing Research Association commenting on the sales in 1982, the fact of the matter was, individual life insurance premiums were almost flat.

A further analysis, however, indicates that the large companies showed a downward trend in premiums on individual life insurance, and the increases were made primarily in the medium and small companies. I would suspect a further analysis would reveal that what you saw was a shift in the premiums in individual insurance from the taxpaying companies to the nontaxpaying companies.

Mr. **Dorgan**. If I might ask just one further question, I was here this morning when Professor Neilson testified, and she said essentially what some of you have said. That is that the policyholder dividends are really refunds of charges that were made to the purchaser of a policy that were overcharges or charges that were not necessary for the purchase of the policy in the first instance, and therefore they refund it in the form of a dividend.

I guess the general question I have is: Do you as chief executives of mutual companies take a look at that revenue in any sense as—at least a portion of the revenue as representing some sort of economic profit to the enterprise that you are running? Do you really consider it the way Professor Neilson described it and the way some of you have tried to describe it, as simply an overcharge that goes back in the form of policyholder dividends?

Is there any form of economic profit here to the enterprise?

Mr. **Gerken**. I will speak for my case. I do not look upon that as any part of economic profit. We look at our total income. What we really look at is hopefully a growing mutual life company. We have a need for increasing our surplus, and we also have a need to be competitive, and we balance these things, and we try to remain competitive with our participating policies by increasing our dividend scale.

We were unable to do that for 3 years, much to the consternation of our field force. We just increased it modestly, but mainly for competitive reasons, because we still have the need to increase our surplus.

I might add that in my opinion, the capitalization of most life companies and all financial institutions over the last 3 years was not at the level it perhaps should have been given the kinds of interest rates we had and what it did to the marketability of assets and so forth.

So, I do not look upon this industry or the banking industry or the S&L industry as being overly strong in terms of its capital and surplus position. Therefore, I am saying that we need to strengthen it, and that is my position.

Mr. **Creedon**. I would just comment a little further. The theory, at least, in a mutual life insurance company, is that you furnish the insurance as close to cost, your actual cost, as you can, and in the process of doing that, you do move money into your surplus, and the concept is that eventually that money with respect to any particular group of policies moves out of surplus, again, or most of it does. There may be some element that is retained, but most of it is moved out eventually and paid either as an annual dividend, or in our case we pay something called a terminal dividend. The contract is eventually canceled. You pay a final dividend which is contemplated as being the return and bringing it as close to cost as you can.

Mr. **Dorgan**. I appreciate your answers. You all obviously have a very good understanding of your industry and how your companies operate, and the stocks do as well, I am sure. We are simply trying to understand both areas as best we can, and try to find our way through this thicket. When we started on this venture, it was clear to me that the simple approach is to find out what life insurance companies made, and you tax them, and I discovered that the complexities here are absolutely staggering. We appreciate your patience and your fine testimony.

Mr. **Groom**. Congressman Dorgan, if I could add one additional comment, I think Professor Nielson went a step beyond simply saying that the dividend was a redundant premium. As I understand her testimony, she also said, in effect, let us take the approach that somebody like Secretary Chapoton is suggesting, and let us compute what an imputed tax base for mutuals might be if you took their surplus and assigned to that a rate of return.

And according to her testimony, as I understand it, she made a whole series of these computations. Then she compared that tax base with the retained earnings, the actual gain from operations that mutual companies report after dividends, and she found that her imputed tax base was smaller than the actual tax base that would arise if you had a gain from operations.

So, having followed the kind of approach that was being suggested by Secretary Chapoton, she concluded that—if it was done properly—it would produce a very insignificant, or as she even said, in some cases negative tax base. So you have an independent witness invited by the committee who I wish I could claim I had coached, but I am not able to make that claim, and she has essentially taken the same position that we have taken.

Mr. **Dorgan**. I am going to have to go back through her testimony. I read it while she testified. I did not ask her the question that I asked the witnesses here on this panel, but I appreciate your comment. It was my understanding that she was saying pretty much what you are saying, that a policyholder dividend simply, at the front end, simply represents an overcharge that was made that would be returned to the policyholder. Therefore, it is not considered part of the economic profit of the enterprise, and I assume she started from that base and reached therefore——

Mr. **Groom**. I agree with you. I think she was doing both of those things.

Mr. **Dorgan**. Thank you.

Chairman **Stark**. Mrs. Kennelly.

Mrs. **Kennelly**. Mr. Van Fossan, in your testimony you said you thought the 1959 Tax Act should be replaced. You went further and said that TEFRA was not as bad as the 1959 Tax Act, but you did not think it should be extended. I think it is probably obvious to all of us that we are certainly not going to go back to the 1920's for our tax law.

So, instead of a level playing field that we talk about all the time, it looks to me like we have an empty playing field, because we have no tax law for insurance which would do what you have said. As the chairman of—well, I guess you are about the 11th biggest mutual?

Mr. **Van Fossan**. Eleventh mutual. That is correct.

Mrs. **Kennelly**. Are you comfortable with us approaching this question of how you are to be taxed in the short period of time that it looks like we might be working in to redo the taxation of mutual insurance companies?

Mr. **Van Fossan**. Yes, Mrs. Kennelly. My answer to that is yes. I think if the committee can agree that the single economic income basis is a viable basis for taxing a business such as ours, and would in fact create a level playing field, which I am convinced it would. In spite of the other pressures that are going to be on the Congress, I am convinced that the time frame ahead of us is sufficient to move in that direction. I think if you try to tax other than economic income, I would question whether it is practically doable in this short timeframe.

Mrs. **Kennelly**. You say this even when you know that we are thinking about treating policyholder dividends differently, and Mr. Boskin said that would be terribly difficult to figure out. You yourself said that mutuals own stock subsidiaries. We have some pretty difficult issues to be thinking about, and you still think it can be done in the short timeframe such as one session?

Mr. **Van Fossan**. I do. If the committee would agree to pursue the single base of economic income, I think it is doable. Other than that, I do not believe it is.

Mrs. **Kennelly**. Just one final question. It seems to me that the only thing that I can see stocks and mutuals agreeing on is inside buildup and whether it should be taxed or should be left alone. I still cannot to my own satisfaction distinguish your product from any other type of savings type of bank account or a house, a long-term investment. How is your product different?

Mr. **Purvis**. If you take the definition which we propose of life insurance, and you take the ordinary life or level premium concept, we are simply providing for the payment of those premiums through the funds which have accumulated. We are therefore insuring the continuation of the protection for the individual through that method.

Therefore, it is vastly different, in my opinion, from buying term and investing the difference, when you get an entirely different result. Just for example, I do not know, Mrs. Kennelly, in your family connections how many people you know who have started out with buying term, investing the difference, and over a period of 10 years have, in fact invested that difference every month.

There is a social aspect of cash value insurance which has permitted the average middle income American and lower income American to obtain insurance that can be kept in force until older ages. As Mr. Creedon has said, in Metropolitan—the average size policy is $5,000, I believe you said, John.

Mr. **Creedon**. $5,500.

Mr. **Purvis**. It has permitted these people an opportunity not only to provide for themselves and their dependents, but also to contribute to the capital which has made this country really a great country. It has provided a lot of things which would not otherwise have been available. In my own company, we do business in 10 Central and South American countries, and if you want to know something about the value of the life insurance industry, just compare what happens in the countries which do not have it and the countries which do. It is the level premium method that has made the difference. Ordinary life insurance policies and resulting protection have been the real key to it.

Mrs. **Kennelly**. Thank you, Mr. Purvis.

Mr. **Martin**. May I respond to your question, which is very much in my mind, too, about the time that is left to accomplish this, because I do recognize that the life insurance industry itself is slowing down the process by the great divisiveness that exists between us. There are two things that this committee, in my opinion, could do that would speed that process, that would bring the life insurance industry back together, have them reach within themelves a compromise that you would find satisfactory. I think it would happen far more rapidly than anyone imagines. Those two things are these.

If this committee would make clear to all of us that returning back to the 1959 act is not a choice that any of us have, that is—the hope by some companies of going back is a strong impediment now. And second, if this committee would make clear to the entire insurance industry that whatever flaws exist in stopgap you will address if we fail to, I believe you would be astounded how quickly two people who look like they are in a cat and dog fight now will come together in one whale of a hurry, and I am talking about a matter of weeks, not months.

Mrs. **Kennelly**. Thank you, Mr. Martin.

Chairman **Stark**. Then who would come to our hearings? [General laughter.]

Mr. Jenkins will inquire.

Mr. **Jenkins**. Thank you, Mr. Chairman.

I want to express my appreciation to this panel for their testimony, and I appreciate their recommendations for a possible solution. I am not totally adverse to it. I have a lot of questions in my own mind as to whether or not there would in fact be a level playing field, and I want to talk about that, since that is the big question with all of us and with all of you.

First of all, as I look at the joint committee print, I see that the 25 largest mutual companies have total assets of $284 billion at the present time. Now, that has gone from roughly $80 billion in 1959 to over $280 billion now. Obviously, the mutuals have not been shrinking, have they? You have been growing rather rapidly, have you not?

Mr. **Van Fossan**. That is true, Mr. Jenkins, but again, I would respectfully suggest that one not accept those blanket asset figures any more than you accept blanket premium figures.

Mr. **Jenkins**. Or blanket percentage figures.

Mr. **Van Fossan**. Or blanket percentage figures. If I again could refer to my own company where I can speak with more knowledge, our assets have grown from 1971 to 1982 from $2.7 billion to $7.2 billion.

Mr. **Jenkins**. Where has that growth come from?

Mr. **Van Fossan**. Primarily in the group annuity business, from large corporate pension plans, rather than from the sale of individual life insurance.

Mr. **Creedon**. The result of ERISA.

Mr. **Martin**. That is true of us as well, primarily.

Mr. JENKINS. You have not been taking much from the policyholders and putting it over into surplus?

Mr. VAN FOSSAN. I assure you we have not.

Mr. CREEDON. No, sir.

Mr. JENKINS. Let me ask you, of the 2,500 insurance companies roughly, 130 plus mutuals, what would be the effect if we do what you suggest and do away with 818(c)(2)? How would that affect your taxes? Would it be important to you, really, or very minute?

Mr. VAN FOSSAN. If in my own company's case you made no other changes, simply eliminated the 818(c)(2), obviously, my Federal income tax bill would increase significantly.

Mr. JENKINS. The same thing across the board?

Mr. BLOOMFIELD. That is true of our company as well.

Mr. JENKINS. Now, let us take as an example some of these that are in the smaller 500 companies. If we eliminated 818(c)(2), how would it affect their tax bill as compared to the effect that it would have on you?

Mr. VAN FOSSAN. I suspect they would have a smaller negative tax.

Mr. JENKINS. A larger negative tax?

Mr. VAN FOSSAN. Yes, particularly some of the smaller companies. Although as Mr. Martin has stated, we are not proposing that you would simply eliminate 818(c)(2) and leave no incentive for the small companies.

Mr. JENKINS. If we did that, we would simply eliminate from the competitive playing field a huge number of small stocks, would we not?

Mr. MARTIN. Yes, sir. You are quite right. All of us, large and small, stock and mutual, benefit from 818(c), but smaller companies are more dependent on it than are others. So that if we just eliminated that and did nothing else, it would be a disaster for those small 500 companies. It is for that reason that we propose that special exemptions be allowed for them. You must do something else. You are exactly right.

Mr. GROOM. Mr. Jenkins, I was just given a figure by one of our own technical folks that our estimates are that if you eliminated all of 818(c), that is, all methods of revaluation of actual reserves, treasury revenues would increase by $1 billion, of which approximately half would come from mutual companies.

As the panel has said, the mutual company position is that we would be willing to make some adjustment here in the small company area. That is the magnitude you are talking about.

Mr. JENKINS. So, since it would help you, I assume you would prefer to retain it. But it would be the least thing on the plate as far as mutuals are concerned if they had to give something up.

Mr. VAN FOSSAN. Well, our reference again, Mr. Jenkins, was that we would prefer and strongly feel that the more proper tax for all of us is economic income and eliminate all of the arbitrary deductions that are presently tied up in the three-phase system.

Mr. BLOOMFIELD. Our recommendation is that we drop 818(c) generally from the new tax bill, but then specifically take care of the smaller companies through some small tax preference applying both to the smaller stock companies and to the smaller mutual companies, but our recommendation involves the general abandonment of 818(c).

Mr. Jenkins. Well, I know the committee is at somewhat of a disadvantage, because we are not as involved in insurance as you all have been for so many years. We obviously want to be careful that we do not tilt the advantage one way or the other, either to the small companies or the stocks or the mutuals. But it appears to me that if we take the position that 100 percent of the dividends are deductible, one of these smaller companies could not really compete with a Prudential with $62 billion in assets when they do not have any reserve.

That disturbs me, and I would like for you to address that for a moment.

Mr. Gerken. I am not absolutely sure of my numbers, but I would think that the magnitude of a company is not that relevant. It is the relationship of the surplus to the assets as a cushion, so that a smaller company may have a smaller amount to return, but in proportion to its size and its surplus, it is comparable to a large company.

Mr. Jenkins. You mean because they would have fewer possible claims?

Mr. Gerken. Well, we always figure that—Pacific Mutual is about one-twentieth the size of the Pru, give or take, so if they had a lot to distribute, as long as we have one-twentieth of what they have to redistribute, we are in about the same relative position that they are.

Chairman **Stark.** Mr. Guarini will inquire.

Mr. Guarini. Thank you, Mr. Chairman.

Inasmuch as the Secretary stated that budget considerations were really not important, I assume that the importance of these hearings is that the stock companies and mutual companies be put in a fair competitive position with each other. That might be the basic common denominator of why we are all here. Now, was it the advent of the high interest rates, as I understand it, that caused the problem of the 1959 law not working, or was the 1959 law actually inoperative and not feasible in the first instance?

Mr. Van Fossan. The primary factor impacting and coming to the fore on the 1959 act, without question, Mr. Guarini, was rapidly escalating interest rates. That obviously had nothing to do with the complexity of the phase system or anything else, but the straw that broke the camel's back, without question, was the rapid escalation of interest rates in our economy.

Mr. Guarini. But it would have fallen into disuse at any rate.

Mr. Van Fossan. In my opinion, it would have.

Mr. Guarini. I wanted to make the record clear on that. Do most of the mutual companies, in that there are advantages working through a stock company, have stock companies? Do you all have a stock company that you put some of your operations into?

Mr. Gerken. Pacific Mutual just created on the first of this year——

Mr. Guarini. If I were giving someone tax advice, and I saw it was stacked one way, I would not blame anyone for saying, well, let us form a stock company. I am asking you if you are doing that as a matter of practice. Mr. Gerken?

Mr. **Gerken**. Pacific Mutual created a stock subsidiary in California at the beginning of this year, for the reason that if we were to be competitive with certain new products, like the universal life type products, we felt we had to have a stock subsidiary to do it. Otherwise, we would be at a tax competitive disadvantage.

Mr. **Guarini**. You find it necessary to do that?

Mr. **Gerken**. Yes.

Mr. **Guarini**. Is that true about the other companies?

Mr. **Martin**. We have formed five of them.

Mr. **Creedon**. Yes.

Mr. **Guarini**. So everyone does, as a matter of practice, to protect their base?

Mr. **Purvis**. Some of us are not quite that far advanced. We are just getting started, this is because in order to handle the new products and be competitive, we have to turn to the stock subsidiary form of operation.

Mr. **Van Fossan**. I would respectfully submit to the committee that there might be a message in that fact.

Mr. **Zinn**. Mr. Guarini, I would point out that I think one of the aspects of the stock company proposal that mutuals consider to be the most pernicious is the proposal to not allow mutual companies to form stock subsidiaries and have them taxed as stock companies, because if the advantages, the tax advantages are conferred upon stock companies in the scope and magnitude that have been proposed by the stock companies, mutual companies would simply be unable to compete, if they are unable to create stock subsidiaries.

Mr. **Guarini**. Right. However, stock companies would have a much more difficult time forming mutual companies than the other way around. Is that right?

Mr. **Van Fossan**. There is relatively little incentive in the tax law for them to do that.

Mr. **Guarini**. I could not resist that.

Mr. **Purvis**. It is not really too complicated, because we started as a stock company, and we changed to a mutual company. We welcome anybody else who wants to do the same thing. And if you should decide that there is a differential to be applied here in any of these tax laws, we would like to have it held retroactively in effect so that it could be carried forward from our stockholders to our mutual policyowners, whatever the benefit of that law might be.

Mr. **Guarini**. Well, Mr. Purvis, you stated, as I remember your testimony, that there is no difference in the product. Have not the stock companies been much more creative in the product they have been writing that has given them a competitive advantage over the mutual companies, and do the laws create an incentive for the stock companies to write more creative policies? Is there a reason for this?

Mr. **Martin**. They most certainly do. The laws which now permit essentially investment contracts to masquerade as life insurance policies have encouraged such contracts. Within the lingo of the industry, I guess probably Congress as well, they are called tax driven products.

Mr. **Guarini**. You have filed income tax returns as of March 15, and of course you are entitled to two extensions, I understand, until September 15. I am going to ask the stock companies that are testifying tomorrow to make available their 1982 returns and perhaps to go back 3 years before that.

Have you all filed your tax returns and are you aware of your 1982 income, and how much tax you will be paying in 1982?

Mr. **Van Fossan**. I believe we all are.

Mr. **Guarini**. Would you make that information available to the committee so that we have both whatever you report in your annual statement as to your gross incomes, so that we also know how much tax you paid, because then we can see exactly how the stock companies are faring also in regard to meeting their tax responsibilities.

Mr. **Van Fossan**. Do you want that for the last 3 years, Congressman?

Mr. **Guarini**. I think for the last 3 years, and of course 1982 was very, very recent to most of you. If you do not have—if you have not filed for 1982, perhaps you can give us some preliminary figures so that we will at least have some concept when we compare the mutuals with the stock companies.

Mr. **Van Fossan**. We will be happy to do that.

Mr. **Martin**. May I make a suggestion? And that is that we be directed specifically to supply the figures of the cash Federal income tax that is due as opposed to that that might appear on our annual reports that are published. There is a wide differential between those two.

Mr. **Guarini**. Now, you have a GAAP accounting and you have the Internal Revenue accounting. The GAAP you file according to the State laws? Is that correct?

Mr. **Martin**. No, as mutual companies, we do not use GAAP accounting.

Mr. **Guarini**. Not any GAAP at all?

Mr. **Martin**. Statutory, and what I understand you are looking for is, what was the Mass Mutual's tax bill for 1982?

Mr. **Guarini**. That is right.

Mr. **Martin**. Never mind reports to policyholders, which had to be based on estimates prior to this being put in.

Mr. **Guarini**. Right. Now you have some requirements for SEC. The stock companies have a complete responsibility to SEC for reports where you have only in some instances a requirement. Is that correct?

Mr. **Van Fossan**. Only in some of our companies, Congressman, who are in those product lines that would call for SEC jurisdictions. Not all companies. Not all mutual companies operate under SEC jurisdiction.

Mr. **Guarini**. How many reports, can you tell me, are you required to file? The Internal Revenue report, of course, and what other reports would you be required to file with the jurisdictional body?

Mr. **Purvis**. Statutory annual statement for all of us in all the States we operate in.

Mr. **Guarini**. I could not hear you.

Mr. **Purvis**. The statutory annual statement that is required in all the States we operate in.

Mr. **Guarini**. Just so that we can compare alongside the stock companies where you are and then you have an idea where we are coming from, because I want to see what the tax liabilities are and how they are meeting their tax responsibilities, and the differences in the operation between the two companies. So it would be appreciated if you could file at least the last 3 years with us. Thank you.

Mr. **Van Fossan**. Very good.

Mr. **Guarini**. Thank you.

Chairman **Stark**. Gentlemen, thank you all very much for your patience. Your testimony, your cooperation, and that of your staffs and counsels in working with our staff on the committee is greatly appreciated. We will look forward to working with you over the months ahead, and we will see if we can come up with a structure at least which we can all understand. Then once we have had several months of good fellowship and cooperation, we can decide what rate to apply to that structure. Then we can all start to fight like hell, and I will look forward to that as much as I have to working with you. Thank you for being with us.

Mr. **Van Fossan**. Thank you, Mr. Chairman and the committee.

[The following was subsequently received:]

SUPPLEMENTAL STATEMENT
OF
MUTUAL LIFE INSURANCE COMPANIES
ON
LIFE INSURANCE COMPANY TAX LEGISLATION

On May 10, 1983, representatives of mutual life insurance companies testified on permanent life insurance company tax legislation before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. We also submitted at that time a detailed prepared statement. The present statement supplements our testimony and prepared statement by reviewing briefly several basic questions raised at the hearings. We respectfully request inclusion of this supplemental statement in the record of the hearings.*/

1. Should the 1959 Act be Replaced?

The 1959 Act is seriously defective and must be replaced. The 1959 Act distorts competition by taxing similar products differently, and because of unnecessary complexity, the Act lends itself to numerous forms of tax gamesmanship.

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*/ By letter of May 31, 1983, from Robert V. Van Fossan to Chairman Fortney H. (Pete) Stark, Jr., we responded in brief to a number of statements that were made by stock company representatives during their testimony. A copy of this letter is included as an attachment to this supplemental statement.

The need to replace the 1959 Act with a new, permanent law was strongly supported by Subcommittee Members, Treasury, and all other independent witnesses. Chairman Stark commented in opening remarks that a return to the 1959 Act "stretches credibility" and that the Subcommittee members recognize that the 1959 Act is "broken." Assistant Secretary John E. Chapoton stated that in the Treasury's view the 1959 Act contains "some of the most complex and least logical provisions in the tax law," and he concluded emphatically that the law "is seriously flawed and is in need of a major overhaul." Independent Subcommittee witnesses, Professors Henry Aaron and Norma Neilson, also spoke in favor of a fundamental change in the life insurance company tax laws.

Only some stock company representatives spoke in favor of a continuation of the 1959 Act. But this very support is due to the flaws in the 1959 Act. Any company that pays no taxes or has a tax-generated competitive advantage can be expected to resist a change in the status quo.

In sum, the overwhelming weight of the testimony at the hearings supports replacement of the 1959 Act with a simpler, more rational law.

2. Should the Stopgap Legislation be Extended or Made Permanent?

The stopgap legislation is an improvement over the 1959 Act because it moves closer to an economic income tax base. However, the stopgap legislation does not respond to most of the policy concerns with the 1959 Act, and, indeed, it has created new uncertainties. These uncertainties concern the taxation of economically equivalent products issued by mutual and stock companies. Consequently, except as a necessary evil as compared to a return to the 1959 Act, the stopgap legislation should neither be extended, nor used as a basis for permanent legislation.

At the hearings, many Members and witnesses expressed the view that an extension of stopgap legislation should not be considered except as a last resort. We were also encouraged by the resolve of the Subcommittee Members to attempt to achieve a permanent solution this year. As we stated in response to questions, a permanent resolution is achievable this year if the Subcommittee makes it clear to all concerned that it intends to replace the current structure with a simpler, more rational corporate income tax.

3. What Basic Elements Should a Permanent Tax Law Contain?

The goal of a new permanent tax structure should be a corporate tax designed to tax all life insurance companies on their economic income. As corollaries to this principle, the tax law should allow a full deduction for the costs of doing business, including all benefits paid or credited to policyholders, and should provide a reasonable allowance for reserve liabilities. Similarly, noneconomic deferrals and deductions should be eliminated. This approach would put the taxation of life insurance companies on the same basis as the taxation of corporations generally.

This framework is consistent in its general terms with the opening remarks of the Subcommittee Chairman, the testimony of the Treasury Department, and the testimony of the independent witnesses at the hearings. The Chairman indicated that the Subcommittee's goal was to develop an equitable and understandable corporate tax based on a total income approach. The Treasury Department in its testimony outlined a conceptional framework which, except in one respect discussed below, contains each of the principal features we discussed in our testimony. Finally, Professors Aaron and Neilson outlined in their testimony similar total corporate income tax approaches. In sum, those witnesses that believe a new law is needed are in substantial agreement on the basic framework and criteria for a permanent solution.

4. What, If Any, Ownership Differential Should be Imposed Upon Mutual Companies Under a Permanent Law?

The question of an ownership differential presents the most difficult conceptual issues considered at the hearings.

It is also the most critical question because any ownership differential will have a direct impact on the ability of mutual and stock companies to compete in the marketplace. We believe a continuing exchange of views on this issue is needed. However, for the record, let us summarize the mutual company position on this important question.

As a matter of sound tax policy, imposition of an ownership differential on mutual companies is not justified. We object to the ownership differential theories because they all begin with the premise that mutual companies are stock companies in disguise. Mutual companies, however, are fundamentally different in their structure and philosophy from stock companies. To ignore this fact in designing the new legislation would be to base mutual companies' tax liability on a fiction. Mutual companies are organized to provide insurance at cost to their policyholders; they are not organized to earn a profit for an investor. Any fair tax law would acknowledge this fact.

Also, as we explained in our testimony, a total income approach contains an adequate built-in ownership differential. Mutual companies would include all premiums (including purported equity contributions) in income and deduct all payments to policyholders. Stock companies would exclude all equity contributions and would not deduct the return on equity. These rules for mutual companies and stock companies are mathematically equivalent, and thus these rules would provide equivalent company level treatment.

The Treasury Department and Professor Henry Aaron testified in favor of an ownership differential in the form of an imputed return on equity capital. However, neither dealt with the fact that an adequate differential would be imposed through the inclusion in the tax base of all premiums, including purported equity contributions. On the other hand, Professor Norma Neilson's testimony seems to confirm that no differential in addition to the built-in differential would be appropriate. Her research indicates that increases in all mutual companies retained earnings, computed on a total income basis with a full deduction for policyholder dividends, exceeds their imputed return on surplus. Thus, even without any separate ownership differential provision, the imputed return would be fully taxed under the suggested total income tax approach.

Moreover, as Professor Michael Boskin of Stanford University testified, the imposition of an ownership differential on mutual companies would be a move in exactly the opposite direction of most current economic thinking.

Finally, even if policyholder dividends were treated in part as a return on equity, no significant tax at the company level should be required in lieu of a policyholder tax. The critical question is the amount of tax that would be paid by our policyholders on any purported equity return from mutual companies and not what stockholders pay, even if that amount were determinable. The amount of tax our policyholders would pay is de minimis. Most mutual company policyholders are low and middle income taxpayers with insignificant amounts of dividend income. Thus, the current $100/$200 dividend exclusion would largely eliminate any potential tax liability.

As we noted at the hearing, it is very unclear what level of tax is currently paid on stockholder dividends. Although we do not know the exact figures for stock life insurance companies, it is estimated that generally about 20 to 25 percent of all common stock is held by tax-exempt pension funds. Also, stock is often held by other corporations that qualify for either an 85 percent or 100 percent dividends received deduction.

5. Should the Current Rules for Policyholder Taxation be Retained?

Mutual companies support the retention of the current rules for policyholder taxation. However, we would restrict the application of those rules, through a definition of life insurance, to only those policies whose predominant purpose is the provision of life insurance protection.

Under the mutual company proposed definition of life insurance, a life insurance contract is defined as a contract that provides for death benefits and that develops a cash value which does not exceed the net single premium for the current benefits provided under the contract. This definition addresses a number of concerns expressed by Treasury about an appropriate definition of life insurance.

First, policies with cash value accumulations in excess of those amounts necessary to provide life insurance benefits will not fully qualify for treatment as life insurance policies. To the extent of the excess cash value, these contracts are serving an investment rather than a life insurance function.

Second, the cash values taken into account under the definition are those necessary to fund current benefits only. Cash values to fund future increases on benefits will be taken into account only when benefits actually increase. Prefunding future increases in death benefits very greatly increases the investment orientation of a contract.

Third, in order to qualify as a life insurance policy, endowment contracts maturing before age 95 must have a stated maturity date that is no earlier than age 70 1/2 and that will occur at a duration of at least 20 years. As Treasury noted in its testimony, the earlier a policy endows, the greater its investment orientation. Thus, under the proposed definition, endowment contracts that are heavily investment oriented will not qualify as life insurance contracts.

Mutual companies believe that if the proposed definition is adopted, no changes in the tax rules applicable to life insurance policies, including the treatment of surrenders, loans, and withdrawals, would be necessary. Properly defined, the primary purpose of life insurance is to provide protection, and, as such, life insurance does not compete with taxable forms of investments.

6. How Should Reserves be Determined Under an Economic Income Tax Base?

The Treasury Department testified at the hearings that the approach used by life insurance companies to compute their reserves is conceptually sound. However, the Treasury concluded that several aspects of the computation of reserves under current law lead to an unwarranted acceleration of deductions for additions to reserves. The Treasury Department questioned the use of "rule-of-thumb" approximations under Code section 818(c)(2). Also, the use of the net level reserve method was questioned as using unrealistic assumptions to allocate loading charges among premiums. Finally, Treasury asserted that current law allows life insurance companies to use overly pessimistic mortality assumptions to estimate future death claims and unrealistically low interest rates in discounting future liabilities. We agree with some of these points.

First, the Treasury Department's concern with regard to rule-of-thumb approximations is legitimate. For this reason, mutual companies proposed elimination of the approximate revaluation methods under section 818(c)(2). As discussed below, however, this provision has continued justification if specifically targeted as a small company provision.

Second, there is justification for concern about the use of the net level reserve method, particularly where the method is not used for purposes of valuing reserves under state law. Therefore, in the context of an economic income tax base, mutual companies would support a limitation on reserves, such as the use of the Commissioner's Reserve Valuation Method (CRVM) for individual life insurance policies. If this approach were adopted, however, companies should be allowed as a minimum to deduct any current cash value liability to policyholders.

Third, mutual companies believe that the Treasury Department's concern about the use of unrealistic mortality and interest rate assumptions is not well founded. In fact, state law mortality and interest rate assumptions are modified to reflect changes in mortality and economic conditions. However, these assumptions must reflect the long-term nature of the life insurance liabilities. Moreover, since death or surrender benefits may have to be paid at any time, companies cannot merely match their obligations to policyholders with specific long-term investments. The company's actuarially certified assumptions should not be disregarded merely because they appear conservative in the context of short-term trends in mortality or interest rates. Finally, the implicit alternative of federal standards for mortality and interest rate assumptions would add unjustifiable administrative complexity. Accordingly, we urge continued reliance upon the actual interest and mortality assumptions used by companies to compute reserves for state law purposes.

7. Should the Tax Laws Provide Special Incentives for Small Companies?

The tax laws have traditionally provided special provisions applicable only to small companies to foster competition and entry into the marketplace. Mutual companies have consistently supported similar types of incentives for small life insurance companies, both small mutual companies and small stock companies.

Our concern has been that some of the so-called small company incentives in current law are not really limited to small companies. For example, as the testimony at the hearings indicated, section 818(c)(2), which was intended as a small company provision, actually benefits large mutual and stock companies to a greater degree in absolute dollar terms than it benefits small companies.

At the hearings, however, representatives of small companies testified that they rely to a substantial extent on the provisions of section 818(c). Moreover, small company representatives testified that some small companies do not in fact have the computer capacity to use the exact method of revaluing reserves and thus need to rely on approximate revaluations such as those provided under section 818(c)(2). In view of this testimony, mutual companies would support a continuation of 818(c) if it were directed specifically at small companies. For example, we would suggest consideration of a cap of $1 million on deductions available because of the revaluation under section 818(c). To further limit this benefit to small companies, the $1 million amount could be phased out as a company's reserves exceed specified dollar amounts.

R. V. Van Fossan
Chairman of the Board

Mutual Benefit Life
520 Broad Street
Newark, NJ 07101

May 31, 1983

Honorable Fortney H. Stark
1034 Longworth House Office Building
Washington, D.C. 20515

Dear Pete:

On behalf of mutual life insurance companies, I wish to express my appreciation again for the opportunity we received to present our views to the Subcommittee during its hearings on May 10. Your leadership made the hearings meaningful despite the extreme complexity of the subject matter. We remain hopeful that the Subcommittee will now move forward to develop new permanent legislation that will provide fair treatment to all segments of the life insurance industry.

In due course, we will be filing a formal supplemental statement dealing with a variety of new and old issues raised at the hearings. I am writing now simply to respond in brief to a number of statements that were made by stock company representatives in the course of their testimony on May 11.

1. Stock Company Statement: At least 40% of mutual companies' policyholder dividends represent distribution of profits to the companies' equity owners and should therefore be nondeductible.

Response: Even if one were to accept such a theory of mutual company ownership, the maximum justifiable nondeductible percentage is but a small fraction of the number the stock companies suggest, on the order of 3 to 5%.

Any deemed equity contribution by the policyholders of a mutual company is reported in the company's tax returns as premiums. Unless such deemed "equity" contributions are excludible by the company when received (like the equity contributions to a stock company), any deemed return on that "equity," as well as the "equity" itself, must be deductible when paid out. Otherwise, even under the stock companies' theory of ownership, the mutuals would be unfairly disadvantaged.

A full deduction of dividends would not result in avoidance of tax on these equity returns. This fact is confirmed not only by our computations, but also by the studies undertaken by Professor Neilson in connection with her testimony.

2. Stock Company Statement: The mutual companies have enjoyed substantial underwriting profits on which they have paid no taxes.

Response: There have been no untaxed profits and thus there has been no tax avoidance.

What is at issue is the characterization of mutual company policyholder dividends that are paid out of that portion of gross income which is in excess of investment income. Even the stock companies concede that such amounts are refunded to policyholders in their capacity as customers, not in their capacity (if any) as equity owners. Amounts so refunded to customers are not "profits." Calling them "underwriting profits" before this Subcommittee does not alter that fact.

Unlike stock companies, mutual companies are not allowed artifical special deferrals or deductions under the 1959 Act. Indeed, under current economic conditions, the deductibility of policyholder dividends is severely limited. Contrary to the assertion that mutual companies somehow escape tax on underwriting profits, the dividend limitation actually results in a tax base that is greatly in excess of true economic income from all sources.

The stock company assertion is also in direct conflict with their own prepared statement. On page 30 of that statement, the Stock Information Group concludes that the 1959 Act correctly measures a mutual company's income. While we strongly disagree with this conclusion, it certainly contradicts the notion that somehow, in some manner, mutual companies have escaped tax on a portion of their profits. We are forced to conclude that the statement made at the hearings was simply an attempt to divert attention from the incontrovertible fact that an estimated $9 billion of real stock company profits have gone untaxed under the 1959 Act.

3. Stock Company Statement: An "ownership differential" should be imposed on the stock subsidiaries of mutual companies.

Response: The stock companies have never suggested that the policyholders of a mutual company's stock subsidiary are its equity owners. Thus even under the stock companies' purported rationale for the differential, there is no basis for imposing it on such a subsidiary.

The purported rationale for an "ownership differential" is that a mutual company's policyholders are deemed to be its equity owners. But even the stock companies do not claim that this rationale applies to a mutual company's stock subsidiaries. The stock companies would impose an additional tax on these subsidiaries on the assumption (which is unfounded) that such subsidiaries might sell insurance at cost to their nonowner policyholders.

Such an additional tax would, therefore, not be an "ownership differential."

In any event, the stock company subsidiary of a mutual company would not provide insurance at cost to the policyholders of the subsidiary. From the mutual parent's point of view, the investment in the stock subsidiary would be like any other investment and would have to show an appropriate return. To do so, the subsidiary would have to operate at a profit. Accordingly, the fear that the subsidiary would provide insurance at cost is not a real one.

4. Stock Company Statement: The unique nature of the life insurance business justifies the special deductions and deferrals in the 1959 Act.

Response: There is no economic justification for these provisions.

The special deductions and deferrals represent amounts that exceed the company's own estimates of the present cost of its future benefit payments. If these special amounts represented true economic costs, the company's actuaries would make provision for them in the company's life insurance reserves. A tax based on income has no place for deductions or deferrals that represent hypothetical future costs that the taxpayer itself does not expect to incur. Indeed, these special provisions were originally added to the law not in order to determine companies' income with greater accuracy but in order arbitrarily to allocate the industry's total tax burden among its various segments ("segment balance").

Moreover, even if the special provisions once had some secondary economic motivation, developments over the last quarter century have made such a defense of these provisions untenable. First, they have proved unnecessary. Second, stock companies's insurance sales are no longer characterized by fixed-price, fixed benefit nonparticipating policies. Rather, these companies now rely extensively on flexible pricing features, which make their policies economically equivalent to formally participating insurance. Because flexible pricing features shift to the policyholders much of the risk that previously was borne by stock companies, the advent of policies containing such features has ended any need the companies may once have had for special, noneconomic deductions and deferrals.

5. Stock Company Statement: Bottom-line consolidation does not present abusive tax avoidance possibilities.

Response: So long as the phase system of the 1959 Act remains in the law, bottom-line consolidation provides a broad avenue for tax avoidance.

Under the 1959 Act, items of income and deduction can have a 46%, a 23% or a 0% impact on a life insurance company's tax liability. Bottom-line consolidation allows effective tax planning so that losses can be taken at

46% and gains taken at some lesser rate. Assistant Secretary Chapoton referred to these possibilities in his prepared statement (pp. 30-31). The business press has widely reported that, prior to its current difficulties, Baldwin-United made extensive use of precisely such tax avoidance possibilities. It is our understanding that other stock companies are currently employing the same devices.

6. Stock Company Statement: The mutual companies agreed last year to bear 60% of the industry's overall tax burden.

Response: We agreed to support an industry stopgap proposal even though that resulted in a disproportionate tax burden on mutual companies while tolerable for a two year period. For the long term the tax burden must be apportioned according to a company's economic income.

As was demonstrated by our acquiescence to the Rolland-Beck compromise, the mutual companies have been willing to agree to substantial sacrifices in order to achieve broad based consensus on company taxes. Another such concession was last year's acceptance of the stopgap bill. But we did not then and we do not now accept the stock companies' proposition that the tax burden should be allocated in a fashion that ignores companies' economic income. Economic income is the only fair basis for an income tax. If we become successful enough to earn more than 60% of the industry's aggregate economic income, we should pay -- and we are prepared to pay -- more than 60% of the total tax. If we earn less than 60% of the industry's aggregate economic income, tax liability equal to 60% of the total burden would be unjustified.

We expect to elaborate further on these matters in the formal statement we will be filing for the record. In the meantime, we remain prepared to discuss with you in greater detail all issues pertaining to the taxation of life insurance companies and products. We thank you again for your consideration.

Cordially yours,

R. V. Van Fossan

STATEMENT OF MUTUAL CO. EXECUTIVE COMMITTEE

I. INTRODUCTION

In a press release dated July 14, 1983, the Subcommittee on Select Revenue Measures of the House Ways and Means Committee announced hearings for July 28, 1983, to seek comments on a proposal for discussion advanced by Chairman Stark and Representative Moore concerning the Federal income tax treatment of life insurance companies and their policyholders ("the proposal"). The following statement was prepared on behalf of the Mutual Company Executive Committee and summarizes the views of mutual life insurance companies ("mutual companies") on the proposal.

Mutual companies commend the efforts of the Chairman, other Members of the Subcommittee, and staff to develop permanent legislation for taxing life insurance companies. Legislation is critically needed to replace the current complex and inequitable structure. Moreover, we appreciate the concern expressed by Subcommittee Members that the final legislative product be simple, rational, and fair. We believe the proposal is an important first step towards this goal.

Set forth below, in Part II of this statement, is a general overview of mutual company views on the proposal. Part III describes mutual company views on specific provisions.

II. OVERVIEW

The proposal is outlined in a committee print issued on July 14, 1983. In describing the company tax provisions of the proposal, the committee print indicates that the proposal has several fundamental objectives. These objectives may be summarized as follows:

The creation of a new single-phase structure that embodies tax rules applicable to corporations generally and that taxes all life insurance companies on a fair and consistent basis.

The provision of new rules for computing reserves that would more accurately reflect a company's true liability to its policyholders.

The imposition of an ownership differential that would effectively limit the deductibility of policyholder dividends.

The provision of appropriate relief for small life insurance companies.

Mutual companies strongly support each of the basic objectives of the proposal, with the exception of the decision to impose an ownership differential. Even in this respect, however, mutual companies are willing to accept the imposition of a reasonable ownership differential in some form as part of a permanent tax law for the industry.

However, the proposal fails to meet its basic objective of a fair single-phase tax law because the proposal's ownership differential is seriously flawed. Under the proposal's conceptual approach to the ownership differential issue, mutual company taxes are directly related to the level of mutual company equity. Nevertheless, under industry estimates, the mutual share of taxes would be much greater than its share of equity. Mutual companies would pay about 63 percent of the industry's taxes in 1984 if the proposal is applied in its current form. If the effects of transitional reserve provisions are eliminated, the mutual companies' share of taxes would increase to 67 percent. In sharp contrast, the mutual share of the industry's equity, as computed under the proposal, is 49 percent and, on a statutory basis, the mutual share of equity is only 39 percent.

In terms of disallowed dividends, the results under the proposal are more devastating than under the most aggressive stock company suggestion. In the aggregate, over 60 percent of dividends paid by mutual companies would be disallowed under the proposal. For many mutual companies, both large and small, the disallowance would be 100 percent.

In terms of a company's ability to offer its products at competitive prices, the proposal imposes an insurmountable handicap on mutual companies. Our rough estimates indicate that, if 60 percent of a mutual company's dividends are disallowed, a stock company issuing the same product and deriving the same equity return would be able to pay or credit over 100 basis points more to its policyholders than the mutual company could. Thus, the proposal would place mutual companies at a serious competitive disadvantage that could threaten their very existence. It is unsound tax policy to implement such a large disincentive to the mutual form of organization, which benefits consumers by providing insurance at cost.

There are several basic structural and conceptual defects in the proposal's differential. These include the following:

The rate of return used to calculate mutual company taxable return on equity is overstated.

The equity base used to calculate mutual company taxable return on equity is overstated.

The equity return minimum base does not take into account a company's tax preference items.

The equity return minimum base is not applied to stock companies.

The equity return minimum base fails to be a minimum tax base.

The equity return minimum base does not adequately take into account a company's fluctuations in earnings.

These structural and conceptual problems, together with suggested solutions, are discussed in the next section.

III. SPECIFIC ISSUES

A. Company Tax Issues

1. Ownership differential

Mutual companies recognize the practical inevitability of an ownership differential mechanism. However, there are fundamental flaws in the return on equity minimum tax base which the proposal uses to implement the differential. In this section, we describe our specific concerns and some suggested solutions.[1]

(a) The rate of return used to calculate mutual company taxable return on equity is overstated.—The proposal computes mutual company rate of return under a three factor formula based on grossed-up Treasury Bill rates of return, equity return of stock life insurance companies, and equity returns of the Standard and Poors 400 industrial corporations. This rate of return is not a realistic measure of mutual company's return on equity.

If the proposal is to achieve its objective of taxing a company on its income, the most appropriate rate of return would be the company's own portfolio rate. This is the rate of return on invested assets which the company actually earns. If the company's portfolio rate is used, the mutual company taxable return on equity derived will more closely reflect the individual company's actual income.

In all events, under the proposal's own conceptual approach to the ownership differential, the Treasury Bill and the Standard and Poors' factors should be eliminated. The proposal's basic objective is to tax mutual life insurance companies as if they were stock life insurance companies. In this context, the equity returns of stock life insurance companies may have some relevance but the Treasury Bill and the Standard and Poors' factors do not. Even the equity returns of stock life insurance companies will exceed realistic rates of return earned by mutual companies. This is because stock companies can issue highly profitable nonparticipating policies and mutual companies cannot.

(b) The equity base used to calculate mutual company taxable return on equity is overstated.—The proposal adds the reserve for declared dividends, the mandatory securities valuation reserve ("MSVR"), and nonadmitted assets to mutual company annual statement surplus to compute mutual company equity. We believe that each of these add-ons is unjustified. It is most important to the proper operation of an equity return differential that mutual company equity be computed in the same manner as stock company equity is computed for purposes of determining the rate of return discussed immediately above. It is also essential to resolve these add-on issues where they impact differently on stock and mutual companies, such as the dividend reserve and MSVR.

The reserve for dividends that have been declared for payment during the following year is a liability just like life insurance reserves or any other company obligation to expend funds. This liability, therefore, should offset assets in computing equity.

The correct standard for determining whether a liability should reduce equity is not the tax accrual rules. Instead, the correct standard is how the liability affects a company's net worth. A company that has $100 in cash that it is required to repay in six months is not worth $100. In other words, a prospective purchaser of an insurance company would offset the company's assets by the dividend reserve in determining how much to pay for the company.

The 1959 Act and stopgap both recognize the reality of the liability for policyholder dividends, since they allow a full deduction for the corresponding reserves. Similarly, GAAP accounting requires that declared policyholder dividends be carried as a liability, not as a part of surplus. The AICPA's audit guide provides, "A liability is established for dividends payable beyond the end of the accounting period if a commitment to pay such dividends has been made by board resolution." AICPA, Audits of Stock Life Insurance Companies 51 (2d ed. 1979).

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[1] Attached is a memorandum entitled "Imputed Equity Return of Mutual Life Insurance Companies," previously submitted to staff, that discusses many of these issues in further detail.

Contrary to the proposal's approach, MSVR should be excluded from equity so that all assets are consistently valued at book with provision for a reasonable loss reserve. By including the MSVR, the proposal denies mutual companies any loss reserve and uses market value for the companies' stockholdings, which have generally appreciated, and book value for their bonds, which have generally depreciated by a far greater amount. The result is an inconsistent and unjustified computation of equity.

Finally, nonadmitted investment assets should not be considered in computing equity. Nonadmitted investment assets consist of investments which should be written off as wholly or partially worthless and of items whose collection is uncertain, such as overdue receivables. The uncertainty of collection or realization of the value of these investments should be recognized either by excluding these items from assets or providing for an offsetting item as is done for purposes of stock company financial accounting.

(c) The equity return minimum base does not take into account a company's tax preference items.—Under the proposal, stock companies would continue to receive preferential treatment of a number of items such as the company share of tax-exempt interest and dividends received, accelerated depreciation, market value discount and capital gains. However, under the proposal, mutual companies would not receive this treatment because the proposal's equity return minimum base does not reflect tax preferences. The proposal must be changed so that mutual and stock companies aretreated comparably. Accordingly, the equity return minimum base should be reduced by the company's share of tax-exempt interest and dividends received, the excess of accelerated over straight line depreciation and factors reflecting market value discount and capital gains treatment.

(d) The equity return minimum base is not applied to stock companies.—Constructing a mutual company's equity return requires many assumptions with wide margins for error. The minimum base is also a radical concept because it taxes each mutual company on the basis of an average return on equity that may be entirely unrelated to the individual company's economic experience. Consequently, to assure competitive parity, the equity return minimum tax base must also be applied to stock companies. If the minimum tax base accurately measures equity returns, stock companies have no more ground to object to it than mutual companies.

(e) The equity return minimum base fails to be a minimum tax base.—Under the proposal, essentially all mutual companies would be taxed on a constructive base resulting from imputing earnings to equity. The actual operating results of the company would be irrelevant. For federal income tax purposes, it would make no difference whether a company managed its expenditures efficiently, achieved high or low levels of investment and underwriting income, or charged customers high or low prices. In other words, in most or all cases, mutual companies would be taxed on an artificial average approximation of what their income theoretically should be.

Even if one assumes that, in the peculiar circumstances of the life insurance industry, it is reasonable to base part of each company's tax burden on imputed returns, somehow the basic character of the corporate income tax as a tax based on income must be preserved. A possible partial solution is to adjust the minimum tax base so that it imputes returns on equity based on the results of companies whose rates of return are in the bottom half or third of rates of return of all life insurance companies. A way of accomplishing this is to reduce by 25 percent the equity return minimum tax base of both mutual and stock companies.

(f) The equity return minimum base does not adequately take into account a company's fluctuations in earnings.—The proposal's equity return minimum tax base differential is essentially a tax on mutual company surplus. As such, it would encourage companies to reduce their surplus, thereby endangering their solvency and harming consumers. A tax on surplus also does not, without modification, reflect companies' actual economic experience.

Mutual life insurance companies, like other businesses, experience fluctuating earnings. In some years, a company derives more than an average rate of return. In other years, the company derives less than an average rate of return or may even experience a loss. In this regard, group and individual health lines recently have been and continue to be particulary troublesome. Because of competition and soaring medical costs, companies have incurred large losses on these lines of business. The proposal's equity return minimum tax base contains no mechanism to take such losses into account. For this reason, among others, some companies' gain from operations before dividends are less or only slightly more than their minimum bases under the proposal. As a result, most or all of these companies' dividends are disallowed under the proposal.

Regardless of losses and other earnings fluctuations, mutual companies must continue to pay dividends to policy-holders in their capacity as customers to remain competitive. It is unfair and illogical to reduce the percentage of deductible dividends to the extent the proposal does in cases of companies with adverse earning fluctuations. Nor is it sufficient to expect these companies to wait until some indefinite future year in which earnings are sufficiently above average to equalize the situation. The companies' economic positions may have been irreversibly damaged by then. Moreover, some losses may never be recouped.

Several adjustment are needed to take into account fluctuations in earnings. First, for purposes of the differential, the equity return minimum tax base and the gain from operations regular base should be computed on a cumulative basis so that excess taxes paid on the minimum tax base in low-profit or loss years offset taxes otherwise payable on gain from operations in high-profit years. Second, in all events, companies should be allowed to deduct a minimum percentage of policyholder dividends.

Another approach favored by several mutual companies is to change the proposal's equity return approach altogether in favor of (1) a direct limitation on the deduction of policyholder dividends and (2) a minimum tax related to gain from operation before policyholder dividends. For example, the law could provide a direct disallowance of about 5 percent of policyholder dividends and a minimum tax equal to an appropriate percent of gain from operations before policy-holder dividends.

Both of these alternatives would be responsive to companies' own fluctuating earnings experience and the other problems posed by the proposal's differential tax on equity return on surplus.

2. Stock subsidiaries of mutual companies

The proposal suggests applying the ownership differential not only to mutual life insurance companies but to stock life insurance subsidiaries of such mutual life companies. An ownership differential in the form of an imputed return on equity should apply to stock life insurance companies of all types, including stock life insurance company subsidiaries of mutual companies. However, there is not justification for applying an ownership differential to stock life insurance company subsidiaries of mutual companies but to not other stock life insurance companies.

The proposal's justification for applying the differential to a mutual company is that the company's customers are also its owners. This very justification, however, should preclude applying the differential to a stock subsidiary. The application would be wrong because a stock subsidiary is owned by the mutual company parent and not by the subsidiary's policyholders. Accordingly, stock companies should be taxed as stock companies regardless of who owns them, because the policyholders of a stock company are not its owners.

The articulated goal of the proposed ownership differential is "to allow a full deduction for amounts paid to policyholders in their capacity as customers" and to limit the deduction to the extent of "earnings generated by the policyholders' investment in the company." But the role of the policyholders of the subsidiary of a mutual company does not differ in any way from the role of the policyholders of any other stock life insurance company. They are not its owners; they have no "investment in the company."

The central point is a simple one which no stock company representative has yet addressed, much less rebutted. If receipt of policyholder dividends (broadly conceived) creates a deemed ownership interest for tax purposes, then some ownership differential should apply to all stock companies that distribute such dividends. If receipt of such dividends does not create an ownership interest, then there is no way in which the policyholders of the subsidiary are its owners and thus no basis on which to apply any ownership differential to the subsidiary.

Some stock companies allege that stock subsidiaries of mutual companies should be treated like mutual companies because otherwise mutual companies will issue participating business through subsidiaries which will be operated as mutual organizations. As indicated above, the allegation is irrelevant. It is also incorrect. Like all stock companies, mutual company subsidiaries are operated to earn a profit for their shareholders. This has always been the case because of the responsibilities mutual companies have to their policyholders and state law restrictions. There is no evidence that the operation of subsidiaries would or could be changed in the future.

Sound generally applicable tax principles should not be abandoned merely to curb a hypothetical problem.

It follows that the stock subsidiary of a mutual company should be taxed as a stock company. Furthermore, for purposes of the ownership differential provision, the value of the stock of a subsidiary must be removed from the equity of the mutual parent. To tax simultaneously both the earnings of the subsidiary and the equity that underlies these earnings is to impose a second corporate-level tax on what is essentially the same income. All other corporations pay only a single corporate-level tax on the income of a subsidiary. The same should be true of mutual life insurance companies.

3. Reserves

(a) Reserve valuation.—Under the proposal, life insurance companies would be allowed to value their life insurance reserves for federal income tax purposes at the higher of the actual surrender value of their contracts or reserves using the minimum state law valuation bases. The latter would be computed using a full preliminary term method and the highest assumed interest rate and most recent mortality table certifiable under state law. No special deductions for nonpar, A&H, and group term insurance would be allowed.

Consistent with the proposal, mutual companies support the elimination of the use of the net level reserves method to value reserves for federal income tax purposes (except to the extent use of the method constitutes appropriate relief for small companies). As an appropriate limitation on reserves, mutual companies support the use of the Commissioners' Reserve Valuation Method ("CRVM") with a cash value floor for individual life insurance policies. In this regard, we note that CRVM is the modified preliminary term method embodied in the Standard Valuation Law which has been adopted by all the states. CRVM reserves and full preliminary term reserves are different only for policies with net premiums in excess of a 20-payment life net premium. However, few states have ever permitted the unrestricted use of the full preliminary term method for such policies. Accordingly, we continue to believe that reserves for individual life insurance policies should be calculated using CRVM, and not the full preliminary term method.

Mutual companies oppose the limitation in the proposal based on reserves calculated by using the minimum state law valuation bases. The proposal suggests use, for Federal tax purposes, of the highest assumed interest rate and most recent mortality table that the state will allow an actuary to certify. Such use would create numerous serious problems.

For example, use of the highest assumed interest rate certifiable by the state may substantially understate a company's liabilities and may, in fact, result in reserve levels below state law minimums. The requirement to use the highest certifiable interest rate overlooks the fact that states have just recently greatly liberalized valuation standards to provide flexibility, but, to avoid the inadequate reserves that might otherwise result, also require the professional statement of opinion of an actuary as to the adequacy of the level of reserves. In many cases, the actuary may conclude that the maximum interest rate allowed by the state is inadequate because, for example, there is not sufficient assurance that the company can invest the funds or reinvest the earnings on the funds, at the specified rate. Earnings on reinvested earnings represent the bulk of the investment income derived under most contracts.

Also, the hightest assumed interest rate certifiable by the state maybe considerably higher than the rate assumed in pricing the policy. In that circumstance, if reserves were calculated using the higher interest rate, taxable income during the earlier years of the policy would be greatly overstated.

Use of the highest assumed interest rate and most recent mortality table certifiable by the state would also be a tremendous administrative burden. Determining and applying the most liberal valuation interest rate and mortality table prevailing at a given time on a policy by policy basis would be a difficult, expensive, and time consuming task for companies and the Government.

There are also a host of questions and problems with respect to the application of the proposal to reserves for insurance other than indivudal cash value insurance. For example, the proposed surrender value floor is not suitable for pension contracts whose surender values may be subject to unrealized market value adjustments. Although these adjustments reduce the amount the company must pay to the contracthholder on termination, actual termination would produce a loss to the company equal to the market value adjustment. Thus, it would be inappropriate to reduce reserves by the adjustment while not recognizing the offsetting loss. Moreover, it is unclear how the state law minimum requirements would apply to certain reserves, such as reserves for group annuities, retired lives, substandard liabilities, and supplemental benefit riders.

(b) Transitional rules.—In all events, if new rules are established to value reserves, fair transitional rules must be provided. Under the proposal, any difference between the tax reserves computed under present law and the reserves computed under the new rules would be taken into income over ten years. This transitional rule does not take into account that companies obtain significantly different tax benefits from reserve deductions under present law.

Mutual companies have previously proposed that companies be permitted a "fresh start" by allowing them to compute reserves for tax purposes on any new basis without taking any resulting difference into income. This approach would avoid the serious inequities or onerous allocation problems that would otherwise result, given the diverse tax benefits received from reserve deductions under present law. Moreover, there is precedent for this fresh start approach in the 1959 Act.

In all events, companies should not be required to take reserve adjustments into income to the extent that they did not derive a tax benefit from the reserve deductions.

4. Taxable income adjustment

The proposal would allow all life insurance companies a deduction for an amount equal to 25 percent of their otherwise taxable income. Mutual companies oppose the current concept and form of this provision.

The stated purpose for the proposal's 25 percent deduction is to reduce the revenue generated from the life insurance industry to a level slightly less than the revenue estimates projected for the expiration of stop gap. This concept is vitally inconsistent with the mutual company view, and what we understood to be the Subcommitee's view, that the permanent law should not be revenue-driven.

Mutual companies also oppose the structure of the proposed taxable income adjustment. In essence, the proposal gives stock companies an artificial deduction that reduces their taxable income to 75 percent of their economic income. On the other hand, even with the 25 percent deduction, mutual companies are taxed on a base that is greater than their economic income.

Although mutual companies oppose the principle and structure of the proposal's taxable income adjustment, some adjustments to taxable income are appropriate to obtain parity between stock and mutual companies and between financial intermediaries. For example, as discussed previously, mutual companies must be allowed to adjust the minimum tax base for tax preference items to put them on a par with stock companies. Moreover, as discussed further in the next section, life insurance companies should be allowed the same tax benefits from tax-exempt income that other corporations are allowed.

Finally, it may be appropriate to reduce further the tax base or rate applicable to life insurance companies so that the tax burden imposed on such companies is not disproportionate to that imposed on corporations generally and other financial intermediaries in particular. In this regard, it should be noted that effective tax rates on corporations are significantly below the maximum statutory corporate tax rate in almost all industries. Morever, the effective tax rates on commercial banks, a major competitor of life insurance companies, are among the lowest for all industries.

5. Phase III overhang

Policyholders' surplus accounts of stock companies reflect amounts on which tax has been deferred under the 1959 Act. Experience has demonstrated that continued deferral of tax on these amounts is not justified. For this reason, mutual companies support the proposal's option which would include amounts in the policyholders' surplus account in income over a 10 year period.

6. Treatment of small companies

Mutual companies support the provision of appropriate relief for small companies.

7. Tax-exempt income

Mutual companies oppose the provision of the proposal that would continue and make more onerous the rules of present law providing for the proration of tax-exempt income. The proration rule has significantly discouraged life insurance companies from investing in state and municipal obligations. Moreover, application of the rule only to life insurance companies is discriminatory.

The proration concept as applied to life insurance companies was enacted as part of the 1959 Act. Since that time, the concept has applied only to life insurance companies. It has not been extended to casualty insurance companies, other financial intermediaries, or corporations generally. It is unfair to continue to apply the proration rule to life insurance companies only. The current proration rule should be repealed, at least until the Congress decides to apply the limitation to all financial intermediaries. In any event, the proration concept should not be extended to reflect all amounts paid or credited to policyholders since this makes an already discriminatory situation even worse.

8. Reinsurance

The proposal would retain the present law rules with respect to reinsurance transactions. Mutual companies support this provision.

9. Foreign tax credit

Mutual companies support the proposal's provision concerning the computation of a life insurance company's foreign tax credit limitation.

B. Policyholder taxation

1. Definition of life insurance

Mutual companies believe that tax treatment as life insurance should be available only to contracts whose primary purpose is to provide life insurance protection. The proposed definition achieves this end by assuring that, in order to qualify as life insurance, a contract must maintain a reasonable amount of risk at all times. Both "Alternative 1" and "Alternative 2" apply reasonable tests which are of similar stringency. Adopting the definition should therefore create a relatively level playing field both for those policies which qualify as life insurance contracts and for those investment contracts which do not.

It should be emphasized, however, that it is essential that the corridor provide under Alternative 1 not be reduced. If it were reduced, companies whose contracts qualify under Alternative 1 would have a substantial competitive advantage over companies whose contracts qualify under Alternative 2.

One further statutory change is required to assure fair competition among life insurance proudcts. A dividend accumulation fund corresponds economically to the accumulation of excess interest as part of a contract's cash value. Despite this economic similarity, current law treats excess interest and compound excess interest much more favorably than it does the dividend accumulations. Competitive equity and economic neutrality, therefore, require an amendment to extend the favorable tax treatment to dividend accumulations, so long as the underlying contract (including the tax-favored portion of the accumulation fund) meets the proposed definition of life insurance.

2. Policyholder loans

The proposal would disallow deductions for interest on policy loans in excess of $50,000. This proposal is unnecessary, unsound, and would unfairly discriminate against traditional annual premium life insurance.

Policyholder loans have always been an important feature of life insurance. In the case of contracts with high cash values relative to premiums paid, however, the investment-orientation of the contract combined with its high loan values may make the contract attractive as a tax shelter for the wealthy. The proposal's definition of life insurance would preclude investment-oriented products from qualifying as life insurance contracts. There is no further need to change the long-establised tax rules for life insurance.

Any prohibition of tax deductions for policy loan interest is unsound tax policy. Taxpayers generally are allowed deductions for interest on loans secured by assets which have appreciated in value. No sound reason exists for treating cash value life insurance any differently.

Congress has recently been considering a wide range of reforms in the areas of interest deductibility. But no such changes should be made only with respect to selective assets. Singling out one type of loan and loan interest associated with the ownership of a particular asset will naturally steer individuals away from the purchase and ownership of such assets. The current proposal would induce purchasers of permanent insurance to commit their available dollars to noninsurance savings vehicles.

Moreover, imposing tax penalties on policy loans would discourage the sale of traditional annual premium products. Unlike deferred annuities and flexible premium universal life policies, traditional products require the payment of an annual premium. Also, traditional products are unique in that they do not permit partial surrenders. If illness or some other emergency creates a need for cash, the policyholder's only alternatives are a policy loan or a full surrender of the policy benefits and forfeiture of insurance protection. As a result, the policy loan feature is an important aspect in the purchase of traditional products—it makes more acceptable to insurance purchasers the long-term forced savings commitment implicit in traditional annual premium products.

The proposal to allow interest on policy loans under $50,000 does not provide an adequate safe harbor. If such a rule were applied to 1981 sales, traditional products would have been effectively eliminated from competing for a substantial portion of the new policies sold in that year by life insurance agents. An independent survey conducted in 1982 concluded that 24 percent of the ordinary life insurance policies sold through agenst in 1981 were in face amounts exceeding $50,000. Policies with face amounts of $100,000 or more constituted 12 percent of all policies issued and accounted for 38 percent of new yearly premiums and 47 percent of new insurance in force. Policies of this size would normally develop a potential for $50,000 policy loans. Arbitrary tax rules should not eliminate traditional products and the agents who sell them from an important segment of the insurance marketplace.

Statistical information volunteered by companies supports the conclusion that making a distinction between large and small policies and resulting policy loans would impose serious hardships on individual companies. One company reports that policies with face amounts of $100,000 or more represented 25 percent of all new policies sold in 1982 (by number of policies), and accounted for 71.2 percent of new face amount and 71 percent of new yearly premiums. A second company estimates that 15 percent of its new business consists of $100,000 plus face amount policies accounting for over $18,000,000 in new premiums. A third company reports that 40 percent of its total new premiums is attributable to policies which will generate cash values in excess of $50,000 by the twentieth policy year. In sum, many companies will be harmed by the proposal and some companies will be significantly weakened.

Existing law already contains meaningful limitations on the deductibility of policy loan interest. Generally, interest on policy loans and other indebtedness incurred to purchase cash value life insurance is not deductible unless the policyholder pays at least four of the first seven premiums in cash and not with borrowed funds. These limitations, together with an improved definition of life insurance which would outlaw investment-heavy products, provide adequate safeguards in this area.

Finally, the recommended effective date for this proposal is harsh and unfair to existing policyholders who have entered into long-term insurance contracts in reliance on existing law. To avoid this unfairness and to prevent the wholesale lapse and surrender of existing policies, any changes in policyholder tax rules should be made applicable to new policies only.

3. Computation of investment in the contract

Under existing law, a policyholder of a permanent life insurance contract pays a tax on amounts actually received prior to death (consisting of such items as surrender, partial surrender, dividend, and supplementary contract payments) to the extent such amounts exceed the policyholder's investment in the contract. "Investment in the contract" (or basis) is calculated with reference to premiums paid by the policyholder minus amounts previously received which were nontaxable.

Under the proposal, the policyholder's "investment in contract" would be further reduced by amounts not actually received by the policyholder. Reductions in basis would be made for the pure term insurance costs for the "at risk" protection under the policy.

This proposal is not justified based on considerations of tax policy. Furthermore, the tax burden of this proposal would fall most heavily on older persons approaching retirement age who look to the cash values in their life insurance as a source of providing retirement income under the normal policy settlement options.

Tax policy considerations do not warrant the complex basis adjustments which have been proposed to reflect the benefits of ownership of a life insurance policy. Life insurance is a personal asset the principal benefit of which is admittedly life insurance protection. Benefiting from the ownership of a personal asset, however, is not elsewhere in the tax laws a circumstance requiring a reduction in basis. For example, the benefit of owning other personal assets (rental value of a home, car, furniture, clothes, etc.) does not give rise to a basis adjustment. No such rule should apply to life insurance and certainly not to life insurance alone.

The fact that life insurance is treated as a personal asset for tax purposes already carries with it certain well-established tax detriments. Most important, a loss on the surrender of a life insurance contract is not allowed for tax purposes. The tax treatment of losses on life insurance contracts is consistent with the tax treatment of losses on other nonbusiness assets (homes, cars, furniture, clothes, etc.) which, because they are personal in nature, are not tax deductible. In sum, the proposal lacks evenhandedness by requiring basis adjustments for life insurance contracts but not for any other personal assets.

In addition, the proposal would impact most heavily on older persons and would unsettle long-recognized tax rules which encourage policyholders to utilize life insurance settlement options as a means of supplementing their retirement income. Older insureds—those who will soon retire and whose term cost per $1,000 at risk are high—would, under the proposal, pay higher taxes on maturity of their policies and upon receipt of installment payments under settlement options. Facing higher taxes, these older insureds might lose much of their incentive to keep their policies in force. These persons should not be encouraged to surrender their policies.

4. *Annuities*

Mutual companies do not oppose the proposal's provisions concerning annuities.

MEMORANDUM—July 8, 1983

RE IMPUTED EQUITY RETURN OF MUTUAL LIFE INSURANCE COMPANIES

This memorandum is submitted in response to a paper entitled "The Equity Return to Mutual Life Insurance Companies and Their Policyholders." We understand that this paper was furnished by Sutherland, Asbill and Brennan to Congressional and Treasury staffs on behalf of the Stock Information Group. Copies of the paper, referred to herein as the "SIG paper," were subsequently provided to us.

In an effort to advance the dialogue, this memorandum responds to the equity return theory discussed in the SIG paper, but in no respect should it be considered an endorsement of the paper's basic assumptions. Mutual life insurance companies believe that it is fundamentally wrong to force mutual companies into a stock company tax mold. Mutual life insurance companies make a commitment to provide insurance to policyholders at cost. One group of policyholders does not derive profits from, or benefit at the expense of, other groups. This is different from a stock company in which one group of persons, shareholders, have the objective of profiting from dealings with another group, policyholders.

If, despite the foregoing considerations, a minimum or constructive equity return tax is adopted, it should apply to mutual companies and stock companies alike. A tax on constructive equity return is a radical concept requiring assumptions with wide margins for error over which reasonable persons are likely to differ. There is great potential, therefore, for this constructive tax to result in competitive inequities unless it is applied evenhandedly to stock and mutual companies. This consideration is especially compelling with respect to stock company products, such as universal life and indeterminate premium policies, that are economically equivalent to traditional mutual company participating products. Stock companies should not object to application of the constructive tax to them if it is truly a reasonable approximation of the tax on equity returns that would result if mutual companies were treated like stock companies.[1]

I. GENERAL COMMENTS

At the May 10 hearings of the Select Revenue Measures Subcommittee, three of the invited Subcommittee witnesses, Dr. Henry Aaron, Assistant Treasury Secretary John E. Chapoton and Professor Norma Nielson, agreed on a basic concept for dealing with the ownership differential issue. Under this concept, generally referred to as the "surplus interest approach," a constructive tax base for mutual companies is computed by multiplying their surplus or equity by an appropriate rate of return. Of the three witnesses, Dr. Aaron has done the most work in defining the structural components of the concept and applying the concept to actual industry data, which he did for 1978.[2]

Dr. Aaron's method imputed a return to surplus of mutual companies in 1978 of $1.210 billion. If this imputed return had been the tax base for mutual companies in 1978, they would have been subject to federal income taxes (at the then applicable

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[1] While we have not had the opportunity to undertake a detailed analysis, preliminary calculations indicate that the overall stock company tax burden for 1978 and 1980 would be increased substantially if the SIG paper approach for computing a constructive tax were applied to stock companies for those years.

[2] *See* H. Aaron, *The Peculiar Problem of Taxing Life Insurance Companies* (Brookings Institution 1983).

48 percent statutory rate) of $580 million.[3] Such a constructive tax is obviously substantially less than the $1.7 billion of tax that mutual companies actually paid for 1978. It is also less than the estimated $800 million that mutual companies would have paid for 1978 if their taxes had been computed on the basis of tax law gain from operations after full deduction for policyholder dividends.

Since all of the independent witnesses have suggested that the Congress use some form of surplus interest approach to measure the ownership differential, and since the witness whose work was the most advanced developed a constructive tax base for mutual companies of moderate magnitude, it is not surprising that the SIG paper states that while Dr. Aaron's concept "has merit," its methodology "could usefully be refined." These useful refinements have the effect of tripling the amount of mutual company surplus, increasing the rate of return by over 40 percent and producing a mutual company tax base many times greater than the base produced by Dr. Aaron.

Part II of this memorandum explains why we believe that the equity and rate of return figures used in the SIG paper are grossly excessive. Before turning to these specific issues, however, it is useful to step back and consider a basic question.

Are mutual companies today, or were they in 1978, the type of enterprises that one would reasonably expect to be earning large equity returns? The answer clearly is no.

Although precisely valuing the net worth or equity of any corporation, particularly a mutual company, is very difficult, basic economic facts provide convincing evidence that annual statement surplus does not understate mutual company equity. Adjustments to expand surplus, as the SIG paper suggests, are unwarranted.

The market value of mutual company assets—largely aged, long-term, fixed-income securities—has declined greatly from book value. The market value of the assets of the 10 largest mutual companies is actually more than $50 billion below book value according to our rough estimate based on a market interest rate of 12.5 percent. On the other hand, the reserve liabilities of these companies closely approximate cash values, which are demand liabilities. Clearly, on a liquidation basis, the equity of mutual companies is much less than their annual statement surplus, which generally is calculated using the book value of assets.

Mutual companies have considerable going concern value in addition to their liquidation values, but conditions in the marketplace indicate that these going concern values are insufficient to offset fully the effects of declining asset values.

Mutual companies with aged, low-interest rate portfolios have been competing with various other financial intermediaries, including some stock life insurance companies, banks and money market funds, which are able to offer new money rates. This competitive problem has been exacerbated by financial deregulation and new products emphasizing investment yield.

Illustrated high interest rates offered by competitors have led to dramatic increases in life insurance policy lapse rates and sometimes to cash drains on even the largest mutual companies.

The growth in mutual companies' expenses is greater than the growth in their premiums.

Aged, fixed income assets; demand liabilities; competition from new money rates; "runs on the bank;"—this is hardly a recipe for generating large returns to mutual company "equity investors" as is attested by the well-publicized recent problems of the savings and loan industry. Moreover, others who believe that permanent insurance does not face a bright future might be expected to hesitate before placing a very high value on mutual company equity.

When one attempts to value a mutual company as a going concern for any valuation purpose (including determining solvency), it is reasonable to take into account to some extent the fact that policyholders have not historically exercised fully their rights to demand cash values, even when current market conditions would indicate that it is in their economic self-interest to do so. On the other hand, severe inflation, high interest rates, financial deregulation and increased consumer awareness of pricing changes have brought massive changes to capital markets.

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[3] It is possible to interpret Dr. Aaron's study as disallowing an amount of dividend deductions equal to the imputed return so that the tax base would be gain from operations after dividends plus the amount of disallowed dividend deductions. However, we agree with the SIG paper (p. 32) that the proper application of Dr. Aaron's method is that the imputed return on equity serves as a minimum or constructive tax base. Policyholder dividends should be disallowed only to the extent that they reduce a company's gain from operations below the imputed return on equity.

Consider for example the problems that savings and loans initially had in attempting to compete with money market funds, and the similar problems faced by money market funds when banks and savings and loans were subsequently granted the right to offer comparable products. Mutual companies have similar problems which will be exacerbated by financial deregulation and the entry of other organizations, such as banks, into the life insurance market on a national basis. In this context, historic lapse rate levels lose much of their relevance. Given these considerations, we would suggest that a hypothetical purchaser of the equity of a mutual company would exercise extreme conservativism in valuing the premium that exists because policyholders in the past have not fully exercised their rights to immediate cash.

These fundamental economic facts are totally ignored in the SIG paper. Instead, book surplus is pyramided through a series of steps, each of which is based, at most, on only partial truths. Then, inconsistently, a current market rate of return is applied to this inflated amount. The SIG paper uses many complex computations to analyze the differential issue, but the overall approach can be described by a very simple equation—inflated book surplus times an inflated market rate of return equals a meaningless number.

After all is said and done, the SIG paper produces a tax on mutual companies that is very close to the amount actually paid in 1978 under the 1959 Act, and in this manner seeks to support the competitive inequities produced by that law. The proposals advanced by stock companies at the hearings would increase this advantage through special provisions applicable only to stock life insurance companies. In sum, the SIG paper seeks to maintain a tax law competitive advantage and ignores economic reality to do so.

II. SPECIFIC COMMENTS ON SURPLUS INTEREST APPROACH [4]

The surplus interest approach imputes a constructive corporate tax base for a mutual company by multiplying the company's equity by a rate of return. In this part, we discuss the proper measure of equity, rate of return and rate of tax under the surplus interest approach, and also comment on the additional individual level tax that the SIG paper hypothesizes. It should be recognized, however, that if the surplus interest approach is adopted, a number of critical subsidiary issues would need to be addressed that are not considered here. For example, while the surplus interest approach as it has been discussed assumes a relatively stable positive earnings experience, some companies in fact incur operational losses or have substantial variations in annual earnings. Serious transitional issues would also be presented by the differing surplus positions of companies based upon prior years' experience.

A. *Equity*

We have noted above some of the difficulties of making a market valuation of mutual company equity, either on a liquidation or going concern basis. If a constructive tax base for mutual companies is to be computed, we recognize that market valuation is not a practical alternative. This being the case, the question is how to approximate a reasonable measure of equity. We believe that annual statement surplus is the most reasonable available measure of equity, and this is the figure Dr. Aaron used. The SIG paper, on the other hand, makes four adjustments that have the effect of tripling annual statement surplus. For reasons set forth immediately below, we disagree strongly with each of these adjustments. Moreover, taking these adjustments in combination, we believe that the total mutual company equity proposed in the SIG paper is of such magnitude as to be in the realm of the fanciful.

It should also be recognized at the outset that any equity interest of policyholders in a mutual company is much more limited than the equity interest of shareholders in a stock company. Most importantly, mutual policyholders have no opportunity to market their interests to realize capital appreciation. This is a further reason why it is wrong to expand statement surplus in computing mutual company equity.

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[4] The mutual company position is that the inclusion of mutual company premiums in the tax base imposes the only differential that is appropriate and that any constructive tax base is unnecessary since generally mutual company gain from operations will approximate or exceed any reasonable constructive tax base. The SIG paper attempts to refute this "intriguing" argument at pages 4–5. While we do not agree with the SIG paper's analysis, we will not argue the issue in the body of this memorandum since we focus here primarily on the SIG paper's surplus interest approach theories. However, we have summarized our views on this issue in Appendix A.

1. Unamortized Acquisition Expenses

The SIG paper argues that unamortized acquisition expenses (UAE) represent equity that is not reflected in annual statement surplus so that surplus must be increased by UAE to compute mutual company equity. the resulting increase in mutual equity for 1978 is $10.91 billion,[5] an amount which is itself greater than annual statement surplus. The SIG paper's argument, however, has serious conceptual and technical flaws.

(a) The UAE adjustment is unjustified.—UAE should not be included in mutual company equity because stock companies effectively are not taxed on the return on their UAE. For purposes of computing a constructive tax base, mutual company equity is computed only to ensure that equity returns that are taxed to stock companies are also taxed to mutual companies. To the extent that an item does not produce taxable returns to stock companies, it should not be included in mutual company equity.

Stock companies effectively are not taxed on the returns from their UAE since they currently deduct all of their acquisition expenses for tax purposes, as well as on the annual statement. Expensing of UAE is consistent with general tax policy trends for the treatment of capital assets, which will generate income during future periods. However, expensing the cost of a capital asset is economically equivalent to exempting from tax the return on the asset. Therefore, if UAE were included in mutual company equity, the result would be to tax mutual companies, but not stock companies, on the return on UAE.

If UAE is excluded from mutual company equity, there would be no need for the complex "growth deduction" calculated in the SIG paper, the converse negative deduction that would be needed if business contracted, or for any other adjustment. Exclusion would ensure prospective parity with stock companies which presumably will continue to deduct acquisition expenses currently and thereby not be taxed on the return from UAE. Exclusion of UAE from equity is preferable to the SIG paper's approach which requires estimates of UAE and offsetting growth deductions which are not found in the annual statement or in any other readily available source. These estimates are not only very complex but highly suspect as is demonstrated in the technical discussion below.

A question may be raised as to whether mutual companies should be required to include in equity any UAE that may have been created before the constructive tax base goes into effect. We do not believe any such inclusion is appropriate for several reasons. First, for many years, the dividend deduction limitation has resulted in mutual companies' being taxed on amounts far in excess of their economic income. To this extent, there effectively has been no expensing of acquisition costs by mutual companies and no creation of UAE in the past. Second, the various stock company noneconomic deductions and deferrals have resulted in their being taxed on amounts far less than their economic income. If a constructive tax base corrects for any mutual company assets that may have been created under prior law, correction should also be made for special benefits available only to stock companies under prior law. Finally, any problem that may be caused by mutual company UAE created in the past is only transitional. After several years under the new system, most of any past UAE will have been amortized and there will be no asset to generate a return. In short, the fairest, simplest approach is to exclude UAE from mutual company equity.

(b) The UAE calculation is technically flawed.—The SIG paper makes a number of inaccurate assumptions which do not reflect actual mutual company results. In particular, the paper makes the following major errors:

A survey of several large companies indicates that the typical mutual company acquisition expense to gross premium ratio falls in the range of 100–125 percent with the average being about 115 percent, not 150 percent as asserted in the SIG paper.

Lapse rates are now more than 50 percent higher than the level found by the 1978 study used in the SIG paper.

The proper CRVM adjustment is about 80 percent of the gross premium, not 50 percent as asserted in the SIG paper.

The SIG paper neglects to reduce the UAE by the associated deferred federal income tax expense.

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[5] $7.64 billion computed by the SIG paper from a 10 company sample divided by .7 to account for all mutual companies.

When these inaccuracies are corrected, the UAE for the entire mutual segment is about $1.45 billion, not the $10.91 billion SIG figure.[6] If this $1.45 billion "asset" is multiplied by the 16.08 percent return rate used by the SIG paper (which, as explained below, is itself overstated), the corrected equity return is essentially offset by the "growth" deduction the SIG paper provides, even if this deduction is reduced in accordance with the assumptions we have used to compute the UAE.[7]

2. Policyholder Dividend Reserve

The SIG paper asserts that mutual company equity should include dividends declared but not paid because this amount represents a pool of assets that remains in the company's hands and produces earnings inuring to the company's benefit. This assertion, however, is based on an incorrect understanding of "equity."

Equity equals assets less liabilities. Dividends declared are a liability as much as life insurance reserves or any other company obligation to expend funds. Accordingly, there should not really be any question that this liability is an offset to assets in computing equity. Similarly, there is no question that mutual companies' assets include, for instance, investment income and accident and health premiums that are due but not yet received. The SIG paper seeks to place mutual companies on cash basis accounting for the dividend reserve liability while using the accrual method for mutual company assets.

GAAP, which the SIG paper often seems to be relying on without so stating, requires stock company policyholder dividends to be accrued using an estimate of the amount to be paid. This same principle is recognized in section 811 of the Code and should apply in determining mutual company equity. A company that has $100 in cash that it is required to repay in six months is not worth $100, but the SIG paper's analysis would consider that company's net worth or equity to be $100 by ignoring the offsetting liability.

The annual statement approach of treating the full dividend reserve as a liability without discount is also consistent with normal financial accounting practices relating to short term liabilities, including the liability for declared shareholder dividends. Correspondingly, short term receivables are not discounted but are included in assets at full value. It follows that the policyholder dividend reserve should not be added back to annual statement surplus to compute mutual company equity.

3. Mandatory Securities Valuation Reserve

For purposes of measuring mutual company equity, the SIG paper advocates an adjustment to eliminate the effect of the Mandatory Securities Valuation Reserve ("MSVR"). The paper recognizes that the MSVR plays an important role in assuring the financial integrity of a life insurance company. Despite this, the paper reasons that since the MSVR is not held for the fulfillment of policyholder obligations, it should be added to surplus to determine mutual company equity.[8] We strongly disagree with the reasoning and conclusion of the SIG paper.

The MSVR performs two basic functions. First, to recognize the likelihood of future losses from bond and preferred and common stock investments due to default or similar events, the MSVR provides a reasonable reserve or "contra-asset," similar to a bad debt or loss reserve. In computing equity of a financial intermediary such as a mutual life insurance company, it is entirely appropriate to establish such a reserve. Accordingly, adding this component of the MSVR back to annual statement surplus would overstate equity.

The second function of the MSVR relates primarily to common stocks. Unlike most bonds, other debt instruments and preferred stocks, common stocks and certain other assets are valued on the annual statement at market. The MSVR, however, functions to effectively eliminate fluctuations in the market value of common stocks for surplus. The net result is essentially the same as if common stocks were valued on the annual statement at book (less the loss reserve component of the MSVR) instead of at market.

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[6] Correcting for the expense/premium ratio, lapse rate and CRVM adjustment reduces the 10 company sample UAE from $7.64 billion to $1.95 billion. Taking the deferred tax liability into account further reduces this figure to $1.01 billion, which is then grossed-up by .7 to yield $1.45 billion for all mutual companies.

[7] $1.45 billion × 16.08% = $233 million. The reduced growth deduction is about $210 million.

[8] Citing a leading text, the SIG paper also indicates that the MSVR is basically "a contingency fund or earmarked surplus" and thus implies that the MSVR is not a real liability. S. Huebner and K. Black, *Life Insurance* 631 (10th ed. 1982). However, as explained in another leading text, whether MSVR is regarded as a real liability depends on whether a life insurance company is viewed as a going concern or on a liquidation basis. Since companies are generally designed for permanent operation, the text concludes that the going concern concept has more validity and that MSVR is usually considered as a real liability. D. McGill, *Life Insurance* 873 (Rev. Ed. 1967).

By adding back to surplus the portion of the MSVR relating to fluctuations in the value of common stock, the SIG paper effectively uses market values for mutual company common stock holdings, which have appreciated, while using book values for bond holdings, which have depreciated by a far greater amount. Assets should be valued consistently, and, as applied to common stocks, the MSVR serves this purpose by valuing all assets at book. The alternative is to value all assets at market. The SIG paper, instead, take a "heads I win, tails you lose" approach to asset valuation.

4. *Nonadmitted assets*

The SIG paper proposes including all nonadmitted assets appearing on Exhibit 14 of the Annual Statement in mutual company equity. The assertion is that such assets are "capable of producing (and do produce) a return to the company's owners." A review of the items included in Exhibit 14 indicates that for a portion of them the SIG paper's assertion is incorrect.

There are two broad categories of nonadmitted assets included in Exhibit 14. One category, consisitng primarily of furniture and equipment, would ordinarily be included on a financial balance sheet and arguably should be included in measuring mutual company equity. However, the other category consists of items where collection is uncertain. This category includes such items as a portion of due and uncollected premiums, agents' balances and policy loans in excess of cash values. If these amounts were included in assets, the uncertainty of collecting a significant portion of those amounts should be recognized through an offsetting item, as is done for purposes of stock company financial accounting.

B. Rate of return

For purposes of calculating a return on equity, the SIG paper multiplies its pyramided equity by a current rate of return for taxable, intermediate-term Treasury securities "grossed-up" for corporate taxes at the statutory rate. For 1978, the SIG paper uses the average rate for 7-year Treasury securities, 8.36 percent, which grossed up for corporate taxes at a 48 percent rate yields a rate of return of 16.08 percent. This is in contrast to the grossed up tax exempt bond rate used by Dr. Aaron of 11.3 percent or an average mutual company portfolio rate for 1978 of approximately 7.3 percent. The SIG paper attempts to justify using a taxable bond rate because of an assumption that equity returns, if any, will be fully taxable when received by mutual company policyholders. There are several errors in the SIG paper's rate of return analysis.

1. *Use of a current taxable market return rate overstates equity returns*

There are at least two fundamental defects in the use of a current, taxable bond rate as the rate of return on equity. First, it is inconsistent to use a current market rate of return when the other factor in the equation, equity, is measured on a book value basis. Under current conditions, in which market rates considerably exceed portfolio book rates, the SIG paper's approach will consistently overstate equity returns.

Dr. Aaron used a current tax exempt bond rate in his paper for purposes of illustrating his approach. However, he also recognized problems associated with using a current market rate and suggested that a more refined calcuation would use a moving average of municipal bond rates over a period of three or four years. Use of the moving average comes closer to approximately an average book rate of return and to this extent avoids some of the problems inherent in the SIG paper's approach.

It is also erroneous for the SIG paper to use a taxable bond rate of return on the theory that mutual company policyholders would pay substantial individual level taxes if imputed equity returns were treated like shareholder dividends. We discuss this issue in more detail in Section D and Appendix B. Our analysis indicates that mutual company policyholders would pay little or no tax even if equity returns were treated like shareholder dividends. This is primarily because (1) mutual policyholders are generally in middle income tax brackets, (2) the amounts that could conceivably be considered to be distributed equity returns are relatively small, and (3) the dividends received exclusion is available to offset amounts that would otherwise be included in individual taxable income. Since taxing policyholder equity returns like shareholder dividends would not result in appreciable individual level tax, the use of the taxable bond rate is inappropriate. Dr. Aaron's use of the tax exempt bond rate, on the other hand, comes much closer to matching the facts.

2. *The gross up factor should be the effective rate rather than the statutory rate*

The SIG paper uses a gross up factor of 48 percent, the statutory corporate tax rate in 1978, to compute a pre-tax rate of return.[9] The theory is that once an appropriate after-tax rate of return on equity is determined that amount must be grossed up to take into account the payment of corporate income taxes. However, a correct application of the theory would use an *effective* rate of tax not the statutory rate for purposes of this calculation. And, in the context of the SIG paper's theory of treating mutual companies like stock life insurance companies, the most appropriate effective rate to use is the effective rate of tax on stock life insurance companies.

The correctness of using an effective tax rate rather than a statutory tax rate can be demonstrated very simply. Assume a taxpayer is seeking an after-tax return of $10 on an asset worth $100. Assume further that the statutory tax rate is 50 percent, but, because of special tax provisions, the taxpayer pays an effective rate of 20 percent on this income. The taxpayer needs to earn $12.50 to reach the goal of a $10 after-tax return, since his tax will be $2.50 (or $12.50 x .20). The $12.50 is equal to a $10 after-tax return, grossed up to reflect an effective rate of 20 percent. The statutory rate of 50 percent is irrelevant to the taxpayer since in fact he does not pay tax at this rate.

Estimates of effective stock life insurance company tax rates range widely. In his study, Dr. Aaron calculated an effective stock company tax rate of 33 percent for 1978, although he noted that his calculation does not include exempt income or the excludible portion of intercorporation dividends in the income base. Other estimates of the stock company effective tax rate are much lower. For instance, a *Tax Notes* study indicated this rate was about 13 percent for 1981.[10]

It is impossible to predict future effective tax rates of stock life insurance companies. However, in its testimony, the Treasury Department recognized that taxation of the economic income of life insurance companies at the full statutory rate would be overtaxation as compared with other financial intermediaries, which might be corrected through a lower tax rate or other adjustment.[11] One recent study found the 1981 effective tax rate of commercial banks to be 2.3 percent.[12] Another study found the overall corporate effective tax rate to be 20.5 percent.[13] These rates reflect the impact of various corporate preferences which reduce taxable income well below economic income. Most of these preferences are likely to remain in effect. It is reasonable to expect that effective rates for stock life insurance companies also will continue to be substantially less than the statutory rate.

3. *The rate of return should be the company's portfolio rate*

We suggest using a company's own portifolio rate, computed on a book basis, without gross up, as the most reasonable estimate of a rate of return. A portfolio book rate of return is consistent with the book value calculation of annual statement surplus and reflects the relatively small risk entailed by the issuance of participating products by mutual companies. Morover, the use of the company's own rate of return has the advantage of tying the imputed equity return to the company's own earnings experience. The use of a rate external to the company will inevitably result in fluctuations that are largely unrelated to the company's actual economic position.

The portfolio rate is also a simple, practical approximation of using Professor Aaron's grossed up municipal bond rate as the overall rate of return. Although under current conditions mutual company portfolio rates and long-term municipal bond rates are about the same, normally the latter are about two-thirds of the former. If a rate equal to two-thirds of the portfolio rate is grossed up to reflect a 33 percent effective tax rate, the result is equal to the portfolio rate. I stock company effective rates are lower than 33 percent, the portfolio rate would normally exceed the grossed up municipal bond rate.

The SIG paper criticizes the portfolio rate by asserting that this rate reflects only a return on invested assets rather than a return on equity. This criticism is invalid. Portfolio rates exceed the rate of return on assets. A very substantial portion of investment yield computed on a portfolio rate basis is used to pay insurance expenses and the costs of acquiring policies rather than actually increasing policy values. Investment yield of a stock company that is used to pay, for example, agents' commissions, is not return on equity to that stock company, and neither should it be considered return on equity to a mutual company.

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[9] An amount is "grossed up" simply by dividing the amount by one minus a gross up factor.

[10] Tax Notes, "Effective Corporate Tax Rates in 1981," 612 (1982) (hereinafter cited as Tax Notes). This rate and rates cited below are for U.S. tax on U.S. income.

[11] Statement of John E. Chapoton, Assistance Secretary, Department of Treasury, Before the Subcomm. on Select Revenue Measures, House Ways and Means Comm. 20 (May 10, 1983).

[12] Joint Committee on Taxation, "Taxation of Banks and Thrift Institutions" 9 (Comm. Print 1983).

[13] Tax Notes, *supra* at 578.

The SIG paper's criticism also ignores the fact that an individual can make an "equity " investment in a mutual company only if he or she also becomes a customer of that company. The two investments—as equity owner and as customer—are inseparable. It is as if to buy $100 of stock in General Motors an individual also had to expend $10,000 to buy a GM truck without having the ability to resell the truck. Accordingly, it is inappropriate to treat the mutual policyholder as having two different investments with two different rates of return. Instead, the policyholder has made one investment with one overall rate of return. Mutual policyholders do not derive a leveraged margin from other policyholders. The fact that one assumes that some part of the policyholder's return should be taxed as equity return does not justify artificially bifurcating the overall rate of return into different equity and customer rates of return.

As an analogous case, consider an individual who purchases a certificate of deposit paying a stated interest rate from a bank on the condition that the individual also open a noninterest bearing checking account. A proper accounting of the return on the individual's investment would not be the stated CD interest rate but would also reflect the detriment of the zero interest checking account deposit. It would be wrong to consider the CD apart from the deposit since the two are inseparably linked in the same way that the "equity" and customer investments of the mutual company policyholder are linked.

Furthermore, the market in which mutual policyholders are suppliers of capital is a different market from that of stock company shareholders, and policyholders, who regard themselves as customers, demand a lower rate of equity return, if they demand any, than do shareholders. Finally, under current conditions, mutual companies' investment income is not sufficient to provide profit margins after crediting policyholders with rates of return comparable to those offered by their competitors.

C. Rate of tax

Under the SIG paper's approach, a mutual company's constructive tax base is its equity multiplied by a rate of return. Once this base is computed, it is multiplied by a rate of tax to determine the company's constructive corporate tax.

The SIG paper multiplies the constructive base by the statutory corporate tax rate rather than the effective tax rate of stock life insurance companies. However, since their theory is that the tax burden on mutual companies should be comparable to the tax burden on stock companies, the effective rate on stock companies is the correct benchmark. The reasons for using the stock company effective rate as the corporate tax rate to apply to the constructive base in computing the constructive corporate tax are the same as the reasons for using this effective rate as the gross up factor. This is discussed above in Section B.2.

The use of a stock company effective rate may not be practical if the surplus interest approach is adopted, however, because it would entail complex annual determinations. An alternative would be to allow deductions from the constructive tax base to reflect items of economic income which escape tax in the hands of stock companies. At a minimum, this would include deductions for the company's share of tax-exempt interest and dividends received, the excess of accelerated over straight line depreciation, a portion of capital gains to take into account the alternative tax rate, and any other general corporate preferences. Moreover, capital gains that have effectively been taxed by imputing returns to assets that are later sold should not be subject to tax on sale. Otherwise these gains would be taxed twice.

In addition, any special stock life company provisions—such as group deduction or deferrals—should reduce the mutual company constructive tax base. The surplus interest approach can achieve some measure of parity between mutual and stock companies only if any provisions enabling stock companies to escape tax on their equity are also taken into account in computing the mutual company constructive tax base. The SIG paper to some extent recognizes this principle by granting mutual companies a UAE growth deduction but neglects to carry this principle to its logical conclusion with respect to other tax preference items.

D. Individual tax

The SIG paper asserts that the mutual company imputed tax amount should be increased by the amount of tax that mutual company policyholders would pay if equity returns distributed to them were treated in the same manner as stockholder dividends. The computation of this tax amount is based upon two critical assumptions. First, the SIG paper assumes that mutual company policyholders would pay tax on equity distributions at marginal rate of 25 percent. Second, the paper assumes that approximately 66 percent of after-tax corporate earnings would be distributed to policyholders currently. Both of these figures are substantially overstated.

The SIG paper selects the 25 percent average marginal tax rate without comment or anlaysis. Our analysis indicates, however, that the actual amount of tax that would be paid by mutual company policyholders on any deemed equity distribution would be less than 5 percent.[14] The 5 percent rate results from the interrelationship of three factors. First, mutual company policyholders tend to be average, middle income Americans. (Nevertheless, in order to be conservative, we made some adjustments in our analysis to recognize that those with higher incomes would tend to purchase larger policies.) Second, the portion of any distribution that could be considered equity, even under the SIG paper's approach, it very small. Finally, the bulk of middle income individuals have received substantially less than the $200 of dividends that are allowed to be excluded in calculating taxable income for federal income tax purposes. Thus, for most individuals there would be not tax on the portion of distributions treated as equity returns.

In addition to an inflated tax rate, the SIG paper also overstates the percentage of equity returns that reasonably could be considered to be distributed. The SIG paper arrives at the 66 percent figure by use of a ratio of policyholder dividends to gain from operations before such dividends. This ratio is arbitrary, and the paper offers no rationale for it.

There is no justification for concluding that mutual companies distribute a greater percentage of their purported equity returns to their policyholders than the percentage of equity returns stock companies distributed to their shareholders. A review of the financial statements of the larger stock companies indicates that they distribute approximatley 30 to 40 percent of their earnings as computed under the SIG paper's approach, or about half of the rate of distribution the SIG paper attributes to mutual companies.

If correct tax rate and distribution assumptions are used, the amount of tax that should be imposed on mutual policyholders' distributed equity returns would be *de minimus.*[15]

III. CONCLUSION

The SIG paper ignores the true economic position of mutual companies today and, at virtually every step of its analysis, uses inappropriate figures to inflate mutual company constructive equity return beyond any reasonable level. It is incorrect to compute equity by expanding mutual company annual statement surplus and to use a current, taxable rate of return. It is also incorrect to use statutory rather than stock company effective tax rates in computing the rate of return and the constructive corporate tax. Moreover, contrary to the SIG assertions, no significant individual level tax would be paid if equity return distributions to mutual company policyholders were treated as shareholder dividends.

If the surplus interest concept is adopted, the simplest, most reasonable and most equitable constructive corporate level equity return tax base is the product of the company's annual statement surplus and its portfolio rate of return. To compute the constructive tax, this base should be multiplied by the stock life insurance company effective tax rate. Alternatively, the constructive base should be reduced to reflect preferences granted to stock companies. Moreover, no policyholder level adjustment is necessary because of the minimal tax such an adjustment would produce. Finally, any constructive tax base should apply to stock and mutual companies alike to ensure tax neutrality, and must also provide for adjustments to account for annual earnings variations and transitional problems.

Theodore R. Groom, Groom & Nordberg, Chartered, Washington, D.C.
Matthew J. Zinn, Steptoe & Johnson, Chartered, Washington, D.C.

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[14] This is an average marginal rate and thus, of course, some policyholders would pay tax at at a higher rate and others at a lower rate.

[15] The correct tax rate is less than 5 percent (⅕ of the SIG paper's rate) and the correct distribution amount is 33 percent (½ of the SIG paper's figure). Accordingly, even using the SIG paper's figure for corporate equity return, the individual tax would be only $31 million (the $314 million computed by the SIG paper × ⅕ × ½). If a more reasonable corporate equity return figure is used, even this small tax is substantially reduced.

APPENDIX A

TAXATION OF MUTUAL COMPANY PREMIUMS

Mutual companies have proposed that all companies be taxed on their economic income and that the best measure of economic income is gain from operations after a full deduction for dividends and similar distributions paid to policyholders. Stock companies have contended that such a tax base is unfair because it does not recognize an "ownership differential." In response, mutual companies have pointed out that a gain from operations tax base would contain a built-in ownership differential, since under such an approach the so-called owner-contributed capital (in the form of premiums) would be taxed to the mutual company.

The SIG paper's rebuttal to the mutual company position is incorrect as to some points and evasive as to others. It is incorrect to contend, as the SIG paper does, that the stock company capital base consists of "retained coporate earnings, which already have been subject to the corporate tax . . ." In this regard, the SIG paper astonishingly omits any reference to the $9 billion in retained earnings which have not been taxed to stock companies as a result of the special deductions and deferrals under the 1959 Act. Nor does the SIG paper mention the substantial benefits stock companies have derived under section 818(c).

For many years prior to the 1959 Act, stock companies earned underwriting profits which were not taxed at all. Indeed, the failure of the pre-1959 law to tax all stock company profits was one of the principal factors leading to the enactment of the 1959 Act.

Stopgap continues the pattern of prior legislation in that it does not fully tax stock company retained earnings. Stopgap does not eliminate the special deductions and deferrals which enable stock companies to earn and retain profits without paying a full tax on such amounts. By one estimate, $400 to $500 million of stock company profits escape taxation each year under Stopgap.

With respect to the treatment of mututal company equity capital, the SIG paper devotes much of its rebuttal to a vain attempt to prove that mutual company premiums have not been taxed under the 1959 Act and Stopgap. The SIG paper thus does not confront the basic point that a new law based on economic income would include all premiums in taxable income. Such a law, therefore, would impose a built-in differential by subjecting the retained capital contribution component of premiums to tax.

Moreover, the SIG paper's assertion that mutual company equity capital has not been taxed under prior law is erroneous because it ignores the treatment of mutual company retained earnings under the 1959 Act and Stopgap. Under the 1959 Act, mutual companies have paid tax on gain from operations with a limited deduction for policyholder dividends. In other words, mutual companies have paid a tax on all retained earnings (that is, gain from operations after all dividends are subtracted) plus a tax on additional amounts of income which are created when some portion of dividends is not deductible.

Mutual company retained earnings continute to be taxed under Stopgap. This is so because, as in the case of prior law, the mutual company tax base under Stopgap is greater than gain from operations after a full dividend deduction. Thus, under Stopgap, amounts retained by a mutual company (plus other amounts distributed to policyholders and not deducted) are taxed.

Simply put, under Stopgap and the 1959 Act, all mutual company retained earnings, and thus all mutual company equity capital , must go through taxable income either as premiums or investment income. On the other hand, stock company paid in equity capital, does not go through taxable income. The SIG paper's discussion of economically meaningless distinctions between underwriting and investment income does not change this basic stock company advantage under the 1959 Act, Stopgap or any future law that includes the capital contribution component of mutual company premiums in income without allowing a full policyholder dividend deduction.

APPENDIX B

COMPUTATION OF MUTUAL POLICYHOLDER TAX RATE ON DISTRIBUTED EQUITY RETURNS

To compute the average mutual policyholder marginal tax rate on distributions of equity return, we assume that the average mutual policyholder is a joint return filer whose adjusted gross income falls within the 71st and 82nd percentiles.[1] In 1978, this is the $25–30,000 AGI group.[2] Even using the stock company figure for mutual company equity return, which we have shown is far overstated, the average equity return distribution received by a mutual policyholder is about $35.[3] Of the $25–30,000 AGI group, 75 percent received no shareholder dividends so that their marginal tax rate on mutual company equity return of $35 would be zero because the $200 dividend exclusion would absorb the entire equity return. For the remaining 25 percent of the AGI group, an averge of $125 of the $200 exclusion was used. As a result, this group's marginal tax rate on mutual company equity return would, at most, be about 17.5 percent.[4] A weighted average of the two groups yields a 4.4 percent average marginal rate.[5]

Chairman **Stark**. Our next panel consists of C. Lowell Harriss, professor emeritus of economics from Columbia University, and Mr. Harry D. Garber, the executive vice president and chief financial officer of the Equitable Life Assurance Society of the United States, and John H. Elkin, senior vice president of Bankers Life.

If you gentlemen are here and would like to come forward. Mr. Elkin is not with the panel, so we will have the pleasure of the testimonies of Professor Harriss and Mr. Garber.

Professor Harriss, we have you listed first. Would you like to proceed with the summary of your testimony which you had submitted to us last week?

STATEMENT OF C. LOWELL HARRISS, PROFESSOR EMERITUS OF ECONOMICS, COLUMBIA UNIVERSITY, ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **Harriss**. I am C. Lowell Harriss, professor emeritus of economics at Columbia University, executive director of the Academy of Political Science.

I appear here on behalf of or at the request of the Mutual Company Executive Committee. However, I want to emphasize that the views expressed are my own. I was delighted with the opportunity to speak on the general subject related to the taxation of capital, because it is one concern for which I have appeared before this subcommittee, the Ways and Means Committee, and the Senate Finance Committee several times over the years.

The taxation of income accrual in life insurance credited to the policyholder, that is, the inside buildup, would be a tax on the rewards to the suppliers of capital. In view of our needs for capital relative to our net savings, I believe that tax policy should not discourage further capital accumulation.

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[1] There is substantial evidence that the typical policyholder is a typical American which would imply using the 50th AGI percentile. However, since higher income persons are likely to purchase larger policies, the equity-return component of policy holder dividends should be treated as received by perosn who income is above the 50th percentile. On the other hand, it should be noted that the largest equities in policies are often held by older persons whose income levels have fallen.

[2] Figures in this Appendix are based on 1978 Statistics of Income, Individual Income Tax Returns, Internal Revenue Service.

[3] The stock company figure for mutual company after corporate tax distribute equity return is $1.257 billion. In 1978, there were about 35 million mutual policyholders, and $1.257 billion divided by 35 million is about $35.

[4] Such persons on average would be taxed on no more than 62.5 percent of their equity return. If we assume that five-eights (62.5%) of such persons have fully used their dividend exclusions, these five-eighths would pay tax on equity distributions at their full marginal rate while the other three-eights would pay tax at a zero rate because of the exclusion. Thus, the average marginal rate of all these persons would be 17.5 percent (62.5 percent × 28 percent—the average marginal rate of the group on all income). Any other assumptions about the use of the dividend exclusions would produce a lower tax rate.

[5] (0 percent × 75 percent + 17.5 percent × 25 percent) /100 percent=4.38 percent.

Taxing the inside buildup which is not now taxed will appeal to some persons as a means of putting those earnings on a par with some of the receipts which are subject to income taxation as distinguished from those that are not. Such taxation, however, would obstruct the building of a capital base for the individual family and the economy as a whole. For the foreseeable future, the accumulation of capital seems to me to be in the best interests of the American public.

I am aware and respectful of the merits of the reasoning in support of including the inside buildup in the policyholder's tax base. Other considerations, however, also belong in an analysis of tax policy for the years ahead. More complete examination lends significant weight to the case against subjecting inside buildup to taxation.

Some explicit concern for improving the capital base of the economy now appears in tax policy, the investment tax credit and IRA's, for example. Not so long ago, a person supporting public policies to encourage capital formation would have risked scorn and rejection as favoring the prosperous at the expense of the common man. Although such attitudes exist, discussions of tax policy can now include explanations of the role of capital in the improvement of human life.

Production depends crucially upon the quality and quantity of capital facilities. Productivity on the job rests upon a complex of factors which include nonhuman elements. Capital equipment takes loads from our backs and makes possible what human beings alone could not possibly accomplish.

A job must be supported by capital. The 1983 Fortune 500 Industrial Corporations report showed that the industry median asset per employee was $66,800. Only with capital facilities on such a scale can a worker produce enough to permit the wages plus fringes expected. Ordinarily, rising real income will be associated with increasing capital per worker. Also, a growing labor force, and ours has been rising by around 2 million a year, requires capital facilities in large amounts.

Technological progress often rests upon new capital facilities. New machines and processes must be created to foster innovation. Many advances in science and technology become available only with new capital.

Housing, State and local structures of many types, environmental needs, and other uses of capital call for substantial amounts of new capital year after year.

Now, these four points and others have at least two aspects in common. First, human benefits are the fruit of capital. Second, quite generally, those persons whose needs are the greatest cannot possibly supply the capital they should have on the job or at home. While poor, a person can save little. If the needs of young persons entering the labor market or setting up homes are to be served, the savings of others must be available. Those others will often be families farther along in life, such as, a couple in their fifties with a life insurance policy that has an accumulated policy reserve.

Tax policy toward capital in general, and life insurance specifically, can profit from recognition that property is an extension of the person. Distinctions such as that between "human rights and property rights," or between "capital and labor," can sadly mislead. What a person owns—or is able to use—affects him or her and the family as human beings.

Governmental policies which reduce obstacles to the acquisition of property will serve to help us to achieve the objectives we seek. Tax policy should not impair life insurance as a means of saving.

Net annual saving—inflation adjusted—for the 30 years through 1981 was around 6.8 percent of GNP. For the last 6 years it was almost one-sixth lower. Such amounts place rather severe limits on the potential for progress.

Americans quite generally, it seems to me, expect a standard of living which requires more net saving and net capital formation than we are providing. Admittedly, this conclusion is subjective. Many questions of concept and definition arise, and statistics are imperfect, but despite any reasons for caution in suggesting capital inadequacy, the longer run prospect seems to me clear enough to call for public concern.

Governmental policy should tilt toward encouraging capital formation. Existing biases against saving should be reduced as budget realities permit. Opportunities to favor capital formation as against current consumption should be given sympathetic examination. Capital enlarges the flow of income. The flow of future income does depend to some extent upon today's capital accumulation.

Federal spending influences the portion of total output directed to consumption. Transfer expenditures, especially social security, tend to shift more of American life toward consumption and away from capital formation. This factor, I submit, adds to the desirability of avoiding new discouragements to saving.

Nontaxation of unrealized accrual seems consistent with other elements of the income tax. The addition year by year which is not converted by the policyholder into cash should not be included in adjusted gross income. Is there not, however, good reason for some eventual accounting? One might reasonably argue that an economic measure of income appropriate for sharing the costs of Government would include any realized net increment built up in life insurance. Whatever the merit of this argument a few years ago, however, conditions have changed. Inflation gradually, then dramatically, has converted a moderate money gain into nothing in real terms, and then brought real losses.

Our income tax has failed to recognize economic reality as applied to thrift accounts, bonds, and other investments fixed in dollar amount. By taxing income, the Government has taken capital erroneously designated as "interest" or "dividend" or "capital gain." The dollars have been used to finance Federal and State spending. The inside buildup has escaped this tax created capital levy.

Inadvertence rather than deliberate design brought about these results. Moreover, the effects of inflation on policyholders have varied widely. Generally, however, many of the insureds must have felt themselves locked into long term contracts. In a world with inflation prospects, some recognition of such a risk will be expected.

However, policyholders in committing their capital to insurance companies probably relied to some extent on the fact that the inside buildup would not be subject to tax.

As a matter of elementary fairness, any attempt now to tax the inside buildup would have to recognize the effect of inflation. A deduction for the accrued loss of real value of the capital would have to be allowed. The imperative of such adjustment to achieve equitable treatment might be less obvious if made at the company level, but the reality would remain.

Inflation has existed and will not be reversed. We do not know what lies ahead. But actions taken now should recognize what we do know.

The fact that holders of thrift accounts and others whose real capital has declined have been overtaxed over the years does not justify extending the erroneous treatment to life insurance. Any change should embody careful, explicit, permanently adjusted methods to offset the effects of inflation.

Pressure to reduce the Federal budget deficit invites attention to possibilities of broadening the tax base. The inside buildup presents a potential object. The possible net benefits, however, seem small. One reason for reducing the deficit is that financing it will draw away funds available for private investment. Yet I should expect that the revenue obtained from taxing insurance would curtail private saving, if not dollar for dollar, certainly on a scale substantially relative to the revenue.

The quip "In the long run we are all dead" by Lord Keynes can seriously mislead thinking. We do have concern for our children and theirs. Life goes on. Actions taken today affect the future, and are often guided by concern for the future.

Whatever one thinks about the best mixture of market and governmental policies, the interest and desires of future generations—in the marketplace or by voting—cannot be adequately reflected today. Decisions to buy and sell in the future or political preferences as reflected in voting in future elections cannot appear in current actions. Do we not have some responsibility for the future? Of course. How? We use our best judgment and instincts. Just as we are the heirs of the ages, profiting from the savings and investments of the past, so we are now acting not only for ourselves in the years left to us, but also for our descendents.

Life insurance epitomizes such concern. One result is the provision for the family. Another is the capital accumulation as a result of insurance financing. The effects spread over the whole economy of a tax change that would hamper such functions would seem to be retrogressive. Thank you.

[The prepared statement follows:]

STATEMENT OF C. LOWELL HARRISS*

PROPOSALS TO TAX THE INSIDE BUILDUP

Taxation of the income accrual in life insurance credited to the policyholder -- the "inside buildup" -- would be a tax on rewards to suppliers of capital.

Implications that such accruals should be included in adjusted gross income have been on various agenda for tax revision. Devising a workable method would prsent major administrative problems. This testimony does not concern the formidable problems of implementation. Rather, it examines the logic and principles of attempting to tax the inside buildup, somehow and at some time.

In view of our needs for capital relative to our net savings, I believe that tax policy should not discourage further capital accumulation. (My discussion does not presume to cover cases in which the pure insurance element is negligible relative to the saving element.) Where possible, some tilt in favor of saving would serve broad interests, present and future.

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*/ Professor Emeritus of Economics, Columbia University, Executive Director, Academy of Political Science, Economic Consultant, Tax Foundation, Inc. This statement was prepared at the request of the Mutual Company Executive Committee. However, the views expressed herein are those of the author and not necessarily those of any organization with which he is associated.

Income taxation in the United States has generally sought to reach rewards for effort -- wages and salaries -- and rewards for the supplying of capital -- dividends, capital gains, rents, and interest. Yet there are many types of income that are not taxed, such as pension fund earnings, IRA's, owner-occupied housing, unrealized appreciation and municipal bond interest. Taxing the inside buildup which is not now taxed will appeal to some persons as a means of putting such earnings on a par with those receipts that are subject to income taxation.

Such taxation, however, would obstruct the building of a capital base for the individual family and the economy as a whole. For the foreseeable future, human well-being would be served constructively by encouraging -- certainly not by discouraging -- the accumulation of capital. In the present context, therefore, I believe choices should be directed toward encouraging rather than hampering capital formation. Of course, the issues are complex.

Tax decisions today should rest upon the assessment of future conditions. Conclusions formulated in a past when circumstances were different and knowledge less complete are not necessarily best now. Two examples:

1. There was a time when some respected economists feared "oversaving." They believed that the U.S. economy

tended to save more than required for the investment outlets available (new capital facilities). Discriminatory taxes against wealth and against income from property ("nonearned income") were thereby defended.

2. Academic writers on tax policy, with few exceptions, once accepted as axiomatic the conclusion that receipts (income) rather than expenditures (consumption) constitute the proper base for taxation. This conclusion provides the basis for much of what one finds in the literature and the official Budget classification of the inside buildup as a tax expenditure. Yet many now challenge the conclusion that income is unquestionably the best tax base. A consumption base may have persuasive merit. Where there is room for choice in tax policy, one is no longer compelled to endorse income rather than consumption as the best tax base.

I am aware and respectful of the merits of the reasoning in support of including inside buildup in the policyholder's tax base. Other considerations, however, also belong in an analysis of tax policy for the year ahead. The more complete examination, it seems to me, lends significant weight to the case against subjecting inside buildup to taxation.*/

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*/ One point not discussed should be noted. The savings element, as well as the insurance element, of life insurance premiums will be subject to a state tax of 2 percent or so, perhaps more; as a tax on capital this levy, although rarely discussed, should be kept in mind.

The Need for Capital Formation

Some explicit concern for improving the capital base of the economy now appears in tax policy -- the investment tax credit and IRA's, for example. Not so long ago, a person supporting public policies to encourage capital formation would have risked scorn and rejection as favoring the prosperous at the expense of the common man. Although such attitudes exist, discussions of tax policy can now include explanations of the role of capital in the improvement of _human_ life. Capital is valuable only because it serves people well enough to get rewarded. Let me cite four ways in which capital serves mankind.

1. Production depends crucially upon the quantity and quality of the capital facilities with which a person works. Productivity on the job rests upon a complex of factors which include _non_-human elements -- the machines, energy sources, transport, inventory, and so on. For the individual worker, and for the entire economy, _real_ income rises as the capital base expands. Capital equipment takes loads from our backs and makes possible what human beings alone could not possibly accomplish, _e.g._, the miracles of modern communication and the speed of modern transportation.

2. A job must be supported by capital. The 1983 FORTUNE 500 INDUSTRIAL CORPORATIONS showed that the industry median asset-per-employee was $66,800. Only with capital

facilities on such a scale can a worker produce enough to permit the wages (plus fringes) expected and received. Ordinarily, rising real earnings will be associated with increasing capital per worker. Also, a growing labor force -- and ours has been rising by around 2,000,000 a year -- requires capital facilities in large amounts to equip new workers. Finally, as the employed labor force must support an increasing number of nonproducing retirees, the weight of the burden will depend in part upon the amount of capital equipment supporting the worker.

3. Technological progress often rests upon new capital facilities. New machines and processess must be created to foster innovation. Many advances in science and technology can become available -- to consumers as new products and services or to producers as greater efficiency -- only with new capital. Of course, some adaptation of older and existing capital (and financing from depreciation funds) will serve for the new. Yet our ability to exploit the potentials for progress -- for the benefit of all -- will depend to a significant extent upon new capital. The adequacy of resources which are usable for moving ahead will affect the speed of progress. Moreover, the easier the access to new capital, the greater the flexibility for adjusting rapidly to new conditions, such as foreign competition.

4. Housing, state and local structures of many kinds, environmental needs, and other uses of capital call for substantial new capital -- year after year. Some must go for an expanding population, some is needed because people change locations. Improving the quality of existing facilities to meet only moderate standards would absorb billions of savings a year. Obtaining the quality more properly thought of as "American aspiration" would cost billions more a year.

These four points by no means exhaust the list of desirable uses of new capital. All have two aspects deserving explicit note. (1) Human benefits are the fruit of capital. (2) Quite generally, those persons whose needs are the greatest cannot possibly supply the capital they "should" have -- on the job or at home. While poor, a person can save little. If the needs of young persons entering the labor market or setting up homes are to be served, the savings of others must be available. Those others will often be families farther along in life, for example:

A couple well into their fifties has whole life policies which have gradually built policy values; the interest (and other income) under present conditions can go to the insurance company's financing of industry or housing. The persons affected positively by the new facilities -- perhaps a younger family -- will have utterly no recognition of the economic reality which has permitted their advance.

Tax policy toward capital in general, and life insurance specifically, can profit from recognition that property is an extension of the person. Distinctions such as that between "human rights and property rights" or between "capital and labor" can sadly mislead. What a person owns -- or is able to use -- affects him or her and the family as human beings. A house, a place to work, a thrift account, shares of ownership in a corporation, an insurance policy, other forms of property extend what a human being can enjoy, and the personal security beyond the body itself.

Governmental policy that reduces obstacles to the acquisition of property will serve to help us to achieve the objectives we seek. Tax policy should not impair life insurance as a means of saving.

Net saving (inflation-adjusted) for the 30 years through 1981 was around 6.8 percent of GNP. For the six years through 1981, it almost one sixth lower. Such amounts place rather severe limits on the potential for progress.

Capital Shortage?

"Capital shortage" is not a term of precision.*/ Yet one thing seems clear to me: Americans quite generally expect a standard of living which requires more net saving and net capital formation than we are providing. Admittedly, this conclusion is subjective. Many questions of concept and definition cannot be answered with certainty in any study of the capital outlook. Statistical sources are imperfect. At any time, especially during a recession, underused capital facilities are evident. (And cannot any shortage of dollars be overcome by the use of the money-creating mechanism?) Despite any reasons for caution in suggesting capital inadequacy, the longer-run prospect seems to me clear enough to call for public concern.

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*/ "Shortage" is presumably indicated by "high" price. Recent and current levels of interest rates have no single explanation but can be noted in this context.

Governmental policies should tilt toward encouraging capital formation. Existing biases against saving should be reduced as budget realities permit. Opportunities to favor capital formation as against current consumption should be given sympathetic examination. Capital enlarges the flow of income. Without presuming that an increase in today's taxes would be offset fully by an equal loss of taxes soon -- the flow of future income does depend to some extent upon today's capital formation.

Federal spending influences the portion of total output directed to consumption. Transfer expenditures, especially Social Security, and its financing (by taxes or borrowing), tend to shift more and more of American life toward consumption and away from capital formation. This factor, I submit, adds to the desirability of avoiding new discouragements to saving.

Response to Criticism of Exclusion of the Inside Buildup

Nontaxation of unrealized accrual seems consistent with other elements of the income tax. The addition year by year which is not converted by the policyholder into cash should not be included in adjusted gross income. Is there not, however, good reason for some eventual accounting? One might reasonably argue that an economic measure of income appropriate for sharing the costs of government would include any realized net increment built up in life insurance. Whatever the merit of this argument a few years ago, however, conditions have changed. Inflation gradually, then dramatically, has converted a moderate money gain into nothing in real terms -- and then brought real losses.

Our income tax has failed to recognize economic reality as applied to thrift accounts, bonds, and other investments fixed in dollar amount. By taxing "income", the government has taken (and takes) capital, erroneously designated as "interest" or "dividend" or "capital gain." The dollars have been used to finance Federal (and state) spending. The inside buildup has escaped this tax-created capital levy. However, the policyholder has suffered the loss of real worth of the capital.

Inadvertance rather than deliberate design brought about these results. Moreover, it is certain the effects of inflation on policyholders have varied widely. The time required to recognize change must have differed greatly. Estimates of future inflation had to be uncertain. The sophistication of policyholders varies. Generally, however, many of the insureds must have felt themselves locked into long-term contracts. In a world with inflation prospects, some recognition of such a risk will be expected. However, policyholders in committing their capital to insurance companies probably relied to some extent on the fact that the inside buildup would not be subject to tax.

As a matter of elementary fairness, any attempt now to tax the inside buildup would have to recognize the effect of inflation. A deduction for the accrued loss of real value of the capital would have to be allowed. The imperative of such adjustment to achieve equitable treatment might be less obvious if a tax is imposed at the company level. But the reality would remain. Inflation has existed. It will not be reversed. We do not know what lies ahead. But actions taken now should recognize what we know. (The courts might permit Congress to say that capital is income for tax purposes; but sensitivity to justice should set high standards for lawmakers.)

The fact that holders of thrift accounts and others whose real capital has declined have been overtaxed over the years does not justify extending the erroneous treatment to life insurance. Any change should embody careful, explicit, permanently adjusted methods to offset the effects of inflation. (The indexing to begin in 1985 does not provide the type of adjustment called for here.)

Budget Deficits

Pressure to reduce the Federal budget deficit invites attention to possibilities of broadening the tax base. The inside buildup presents a potential object. The possible net benefits, however, seem small. One reason for reducing the deficit is that financing it will draw away funds available for private investment. Yet I should expect that the tax revenue obtained from taxing insurance would curtail private saving -- if not dollar-for-dollar, certainly on a scale substantial relative to the revenue.

Responsibility for the Future

The quip, "In the long run we are all dead" (Lord Keynes), can seriously mislead thinking. We do have concern for our children and theirs. Life goes on. Actions today affect the future and are often guided by concern for the future.

Market forces are powerful. They are affected in many ways by political forces. Whatever one thinks about the best mixture of market and governmental policies, the interests and desires of future participants -- in marketing or voting -- cannot be adequately reflected today.

Decisions to buy and sell in the future, or political preferences as expressed in voting in future elections, cannot appear in current actions. Do we not have some responsibility for the future? Of course. But how? We use our best judgment and instincts. Just as we are "the heirs of the ages," profiting from the savings and investment of the past, so we are now acting not only for ourselves in the years left to us but also for our descendents.

Life insurance epitomizes such concern. It provides for the family. It provides capital formation for the whole economy. Tax change that would hamper such functions would be retrogressive.

Chairman STARK. Thank you, Professor.

Mr. Garber, you may proceed in any manner you see fit. Your testimony, I might add, was extremely interesting. I do want to have some time to get back to your direct and indirect approach calculations. You might want to summarize, so that we can get on to some of the inquiries in that area if that would suit your convenience. But proceed in any fashion that you wish.

STATEMENT OF HARRY D. GARBER, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, ON BEHALF OF THE MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. GARBER. Thank you, Mr. Chairman and Mr. Jenkins.

I am Harry Garber, the senior executive vice president and chief financial officer of the Equitable Life Assurance Society.

I appreciate the opportunity to appear before you and discuss this important subject. My intention, Mr. Chairman, is to talk about the issues which surface when one tries to go about the task of measuring the investment income that is available to individual life insurance policyholders and annuity contractholders.

I sought to make five points in my written testimony. I would mention all five, but elaborate on a couple of them which I think are deserving of more attention.

I hope that you have my written testimony before you, because I would like to refer to a couple of the charts in the back there, and it would be easier if you could look at them.

First, I would like to say that the tax should not be imposed implicitly on the investment income available on individual life insurance policies in order to stem the proliferation of investment contracts masquerading as life insurance policies. To adopt this course would, as the saying goes, throw the baby out with the bath water.

Instead, these problems should be solved through a tightened definition of what constitutes life insurance.

My second point is a demonstration of the importance of investment income to the viability of a whole life insurance policy. Any tax which is imposed implicitly or explicitly on the investment income available under these contracts with the purpose of equalizing the tax treatment of life insurance and certain investment vehicles must exclude some minimum level of this income if whole life insurance is to remain a viable product. My written testimony shows that a minimum of 3 percent is necessary really to make whole life viable as compared with term insurance.

My third point deals with expenses, and this is one I will elaborate on. The 1959 act and all its predecessors define the expenses that were deductible in computing taxable investment income as only those expenses which one incurred in the process of acquiring investments and administering those investments. They considered only the asset side of the balance sheet. No credit is given for the cost of obtaining the funds which were invested, those funds coming from individual life insurance contracts, pension contracts, and so forth.

Other intermediaries—banks, brokerage houses, and so forth—clearly determine crediting rates and loads and fees, taking into account the expenses that they incur. The customers or accountholders are taxed on the net amount they receive, not on the intermediaries' gross investment income.

So clearly, there is a discontinuity here between the way in which life insurance companies have been treated and in which other intermediaries are treated. To show the significance of this, I would direct you to chart 3, which shows some numbers that are taken from the Equitable. I think the general proportions would be the same for other life insurance companies.

I show the total expenses of the individual life insurance business on the lefthand side and have divided them into the acquisition costs of a life insurance policy, the administration costs of those policies, general overhead expenses, and finally investment expenses, which is the category that is involved with the acquiring and administering of investments.

Then I developed a process to determine how much of each category of expenses is attributable to the invested reserves under the contract, with the balance being attributable to the pure insurance benefits. And to do this, I took all expenses that were clearly not attributable to invested reserves, such as your underwriting expenses and so on, and excluded those. I took the expenses that were clearly associated with investment activities, and attributed 100 percent of those to investment income. The others were prorated on the basis of the division of premium income between the costs of term insurance and the amount that goes to the invested reserves. One could use other methods, but they give approximately the same results.

An important element here I think is that I started over on the lefthand side with about $500 million of total expense. I ended up with about $350 million of expense on the righthand side attributable to investment income. All that we have historically been given credit for in the computation of taxable investment income has been that little bit up at the top called investment.

I think that if we pursue the idea of trying to measure how much investment income is attributable to policyholders, we have to begin to take into account the expenses of obtaining the invested reserve amounts in the first place. This is a key issue I would like to raise.

The next issue is also a question of measurement. I would like to make one point first. That is, a key determination in developing any measurement base is deciding first what it is you want to measure. The reason that the 1959 act and all of its predecessors have failed is that the Congress expressed its policy in terms of a formula, and each formula eventually got out of balance with the economic times. We were left with nothing. So that the key decision to be made first is determining what it is you are trying to measure.

My written testimony goes on to illustrate two possible ways of measurement here, assuming that what you are trying to measure is the amount of investment income that is available for individual life insurance policyholders and individual annuity contracts. Chart 4 demonstrates two processes here which I have defined as "direct" and "indirect." The direct process looks at it from the policyholder's point of view. What has he put in? That is a minus. What has he gotten? That is a plus.

So we take account of the cash values received or accredited to him, the dividends received, if it is a participating contract, the term insurance benefits he received, and we subtract the premiums and the base interest credit, the 3 percent or more that we have been talking about.

The indirect approach looks at it from the company's point of view. We start with the company's income statement and attempt to divide up the various elements to determine the portion attributable to individual life insurance and annuity contracts. This is quite complicated and requires a series of allocations that bring that down to the individual contracts——

Chairman STARK. If I could inquire there for a moment. We were under the impression that most of those items, unless you are allocating different investment returns to different groups of assets—for example, qualified pension plans—if one assumes that you merely take the average investment return of your entire investment asset portfolio and then apportion it to various groups, but maybe legally you cannot do that—is that it?

Mr. GARBER. That is not what happens. Most companies recognize different rates, depending on when the investments were made.

Chairman STARK. We were just trying to work backwards. I would concur that your direct approach is far simpler, but we had always been under the impression that in doing some calculations ourselves we were using figures that were fairly readily available.

Mr. GARBER. They are not easily available because of district tax definitions. This is done in the statutory statements, but the tax definitions differ from the statutory definitions for many items of income and expense. This is not an easy process. It would require rules and regulations. It is a complex process and there are a lot of possibilities for companies to manipulate.

In the present tax law there isn't one allocation that I can recall—there is a proration but there is no allocation of this sort. This is something that has been avoided in the life insurance company tax law up to now.

The point I wanted to make is that the direct approach is simpler while the indirect approach is complicated. I wasn't trying to recommend any particular method here, but I did want to highlight the difficulties of the indirect.

The final point I wanted to make was that I have done some fine penciling of the tax numbers that a measurement of investment income credited to individual prolicyholders ought to produce. They depend a lot on how companies with negative numbers (and there are many of them) would be treated. For example, would negatives be carried forward or netted them against the company's tax.

Depending on how negatives are treated the income amount would be about $2 billion at a maximum. It might be as low as half a billion or it might be even less than that. If this income is taxed at an appropriate individual rate, it is only a tiny amount of the several billion dollar tax number that has been floating around here as to what the effect of this kind of process would be.

I would be happy to continue to discuss these subjects, but this one doesn't look to me to be a big revenue item, and it may not be worth all the trouble of going through to obtain such a small result.

[The prepared statement of Mr. Garber follows:]

STATEMENT OF HARRY D. GARBER, SENIOR EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, NEW YORK, N.Y.

Thank you for the opportunity to appear before you today to discuss the taxation of life insurance companies. My comments will be devoted principally to a description of the essential impact of investment income on whole life insurance and to the considerations that must be taken into account in determining how this income should be taken into account in a new life insurance company tax structure.

I am in full agreement with my industry colleagues that a tax should not be imposed implicitly on the investment income available for individual life insurance policies in order to stem the proliferation of investment contracts masquerading as life insurance policies. To adopt this course would, as the saying goes, "throw the baby out with the bath water." Instead, these problems should be solved through a tightened definition of what constitutes life insurance.

The remainder of my statement discusses several issues regarding the measurement of the investment income available on life insurance and annuity contracts and suggests the following four conclusions:

- Investment income is an essential element of whole life insurance. Any tax imposed implicitly or explicitly on the investment income available under these contracts with the purpose of equalizing the tax treatment of life insurance and certain investment vehicles must exclude some minimum level of this income if whole life insurance is to remain a viable product.

- Any measurement of taxable investment income on individual life insurance should permit deduction of an appropriate share of the expenses involved in the acquisition and maintenance of the life insurance policies and not be limited to the expenses directly associated with the investments involved.

- There are several possible ways in which to measure the amount of investment income available for individual life policyholders. My statement illustrates and contrasts two possible approaches.

- Estimates of the amount of investment income available for life insurance and annuity contracts have been greatly exaggerated. Properly measured, the amount of this income is not of such magnitude as to constitute an appropriate base for the imposition of a new and separate tax.

The remainder of this statement supports and supplements these summary conclusions.

Importance of Investment Income in Whole Life Insurance

For over 200 years, life insurance has been sold on a whole life, level premium basis. The need for whole life insurance stems from the path of the term insurance rates required to cover the mortality risks involved. Chart 1 illustrates the premiums per $1,000 of insurance for an Equitable Yearly Renewable Term policy. The price of this insurance is less than $3 per $1,000 annually before age 40 but, after 40, it increases about 9% per year. Shortly after age 80, the annual cost exceeds $200 per $1,000 of insurance, making continuation of the insurance financially unattractive unless death is imminent. Because the very high premiums necessary at the older ages will make continuance of the term insurance difficult, if not impossible, and most policyholders find that insurance needs continue at the older ages, there is a need for a form of life insurance which can be continued without ever-increasing and eventually inordinate premium levels.

Whole life insurance, this product of need and possibility, solves the problem of ever-increasing term insurance rates at the older ages through the payment of a level premium which is greater than the term insurance rates in the early policy years and significantly less than these rates at the older ages. The accumulation of this excess premium in the form of a cash value provides an increasing share of the death benefit as the years go by and reduces to moderate levels the cost of the term insurance for the remainder of the death benefit. The cash value thus is not a side fund but an integral part of the death benefit and of the whole life policy structure.

But some minimum level of interest return is necessary if whole life insurance is to represent a viable option for the buyer. At the time of purchase of insurance, a buyer does not really know whether there is a temporary need for insurance or a long-term need. The initial purchase will usually be made on the basis of the relative costs involved. Whole life insurance, therefore, has to appear to produce additional value that is commensurate with the additional costs involved or it will not be purchased.

Chart 2 illustrates the situation for a buyer age 35. The lower line represents the year-by-year costs of renewable term. The shape of this line is the same as that shown on Chart 1 except that I have included on this chart only ages 35 through 65.

The top line on this chart shows the annual amount which the 35 year old person would have to pay for insurance if there is no interest on the accumulated reserve. This amount would be more than 10 times the renewable term cost in the first year; it would not become less than the renewable term cost until age 64; and it would average 2 1/2 times the renewable term cost over the 30-year period. This would almost always be unattractive to a buyer.

The middle line represents the annual amount which the 35 year old person would have to pay if 3% interest is allowed on the accumulated reserves. This amount is still six times the renewable term charge initially; it does not become less than the renewable term charge until almost age 60; and over the 30-year period it still averages 150% of the renewable term charges. This is saleable, but barely so, relative to term insurance.

Whole life insurance has proven a durable and necessary product over many years. It is not an investment product; the cash value represents an integral part of the death benefit. And, most importantly, a tax-free interest accumulation of at least 3% is necessary to permit this product to be viable in the marketplace.

Treatment of Expenses in Measurement of Investment Income Available for Policyholders

A key issue in the measurement of the investment income available for individual life insurance and annuity contracts is the proper treatment of expenses. Under the 1959 tax formula the only expenses deductible in the computation of Taxable Investment Income are the expenses incurred in securing and administering investments; no effective credit is allowed for the much more significant costs of securing the funds available for investment on life insurance and annuity contracts. Without proper allowance for these costs life insurance companies would be at a severe disadvantage relative to other financial intermediaries where such costs are, in effect, fully deducted in determining the taxable income of customers.

Let me demonstrate my point with an example of data from my company, Equitable Life. In 1982 Equitable Life incurred about $500 million of direct and overhead expenses with respect to its individual life insurance business, which totals about $75 billion of insurance in force. The left-hand side of Chart 3 shows an analysis of this total expense into four general categories, as follows:

- Policy acquisition expenses
- Policy administration expenses
- General overhead expenses
- Investment expenses

The right-hand part of the chart presents the portion of these expenses that should be allocable to the invested reserves under these Individual Life insurance policies. For purposes of these allocations, we recognized that (1) all expenses associated with the purchase and administration of investments are allocable to the invested reserves, (2) all underwriting and related expenses are allocable to the insurance operations (i.e., none are allocable to the invested reserves) and (3) most other expenses should be subdivided between insurance operations and invested reserves on the basis of some reasonable formula. In Chart 3 we subdivided the latter category of expense between insurance expenses and expenses allocable to invested reserves in proportion to the relative amounts of (i) premiums for the term insurance costs and (ii) premiums available for the building of invested reserves, respectively. The total expenses chargeable to the invested reserves amounts to $350 million or about 70% of total expenses.

Please note that under the 1959 tax formula, virtually the only expenses which could be taken into account in determining Taxable Investment Income are the so-called "investment expenses", the upper box on the chart. But, any calculation which purports to measure the investment income available for policyholders must take into account, as well, each of the other types of expense shown on the chart.

In determining the rates which can be credited to customers on savings accounts and certificates of deposit, banks take into account the advertising, branch office and computer expenses which will be involved in acquiring and administering these savings dollars. Similarly, brokerage houses and other financial intermediaries take into account all of the costs of acquiring and administering customer accounts in determining the fund loads and the fee levels on customer accounts.

Life insurance companies must be able to take similar types of costs into account in measuring the investment income which is potentially available as a return on policyholder invested reserves. To fail to do so would place the life insurance policyholder in a significantly disadvantageous position relative to investors in other vehicles, because amounts of income are being taken into account for Federal tax purposes which the policyholder can never expect to receive. Expenses of this type should be treated in a comparable fashion for all financial intermediaries.

Alternate Methods of Measurement of Investment Income Available for Policyholders

There are many possible approaches which could be used in measuring the investment income available for individual life insurance and annuity contracts. The key factor is that the approach must be designed to achieve the specific taxable income measurement desired and not be a formula, like the 1959 tax formula, whose purpose is obscure and which will inevitably become outdated by events.

Chart 4 illustrates two approaches which might be used to measure the investment income available for individual life insurance and annuity contracts. Shown for each approach are the items which must be taken into account in the measurement and for each item there is a letter symbol which indicates the way in which that particular item would be determined. An (A) indicates that the item would be determined by an allocation process; a (C) indicates that the item would be based on a calculation using data in the company's accounting or other basic records; and an (E) indicates that the item is an accounting entry or is otherwise available directly from accounting-type records.

The left-hand side of the chart illustrates what I have labeled as the indirect approach. This approach starts with the company's gross investment income and reduces to the desired measurement through subtractions of (1) the investment income allocable to other types of policies and contracts, (2) the expenses involved in acquiring and administering the invested reserves on individual life and annuity contracts, (3) defined base interest credit (minimum level of 3%), and (4) all amounts of reported policyholder taxable income.

The direct approach, illustrated on the right-hand side of the chart, measures this amount by subtracting from policyholder benefits and credits the premiums paid by the policyholder and the base interest credit. This determination is made only with respect to individual life insurance and annuity contracts that are not qualified pension contracts. The policyholder benefits include (1) cash surrender values received plus the net increase in outstanding cash values, (2) policy dividends or similar distributions received, and (3) the cost of the term insurance benefits provided for the net insurance risk (as determined using the company's term insurance rates). The calculation of policyholder benefits would exclude any amounts that constitute taxable income to the policyholder. The direct measurement thus is based on values which the policyholder has received (or with which he has been credited) less the premiums paid and less the defined base interest credit.

A cursory review of the chart demonstrates the advantages of the illustrative direct approach. It involves many fewer items and all of them are found in the company's books of account or can be calculated from information in the company's books. By contrast, the illustrative indirect approach involves more than twice the number of items in the direct approach and almost all of them are determined through an allocation process, a process which, by its nature, requires statutory (or regulatory) definition and which will surely produce many audit questions and difficulties.

In addition to ease of determination and audit, the direct approach measures the investment income available for policyholders precisely while an indirect approach will usually be, at best, an approximation. The reason why allocations will be required to such a marked degree in the indirect approach is that most companies carry out their several types of insurance operations in one corporate entity, their investments are usually pooled and the activities of many, if not most, employees and agents spread across some or all of these operations. In these circumstances, the basic accounting records will not contain the investment income and expense information required for a direct measurement and allocations must be used.

Finally, the use of the illustrated direct measurement approach would simplify the measurement of the taxable economic income of the insurance company because it is clear that, with the exception of the basic interest credit, the amounts taken into account as positive (negative) elements in the determination of policyholder net investment income credits should be reflected with the opposite sign in the determination of company taxable income.

The purpose of these remarks is not to indicate that a specific direct or indirect approach is the correct measure of the investment income available on life insurance and annuity contracts. What I have sought to show is that an indirect approach involving extensive allocation of investment income and expenses is seriously defective. Moreover, as the failure of the 1959 formula has demonstrated, an indirect approach which avoids allocations and allows limited, defined credits, produces a seriously overstated tax base.

Revenue Estimates from this Source are Exaggerated

Although I do not have refined estimates of the aggregate amounts of investment income available for individual insurance and annuity contracts measured on a direct or a properly defined indirect approach, it appears that this amount is no more than $2 billion and may be as small as $0.5 billion, or even less. This income, if taxed at an appropriate individual rate, would produce only a tiny fraction of the revenue figure often attributed to it, and would add still further complexity to the already highly complicated life insurance tax system.

While we will be happy to continue to explore these issues with you in greater detail, we believe that these explorations will inevitably lead to the conclusion that a tax based on corporate economic income, such as the mutual companies have proposed, provides a more firmly based approach to the taxation of life insurance companies.

CHART 1
Yearly Renewable Term
Premiums Per $1,000 of Insurance

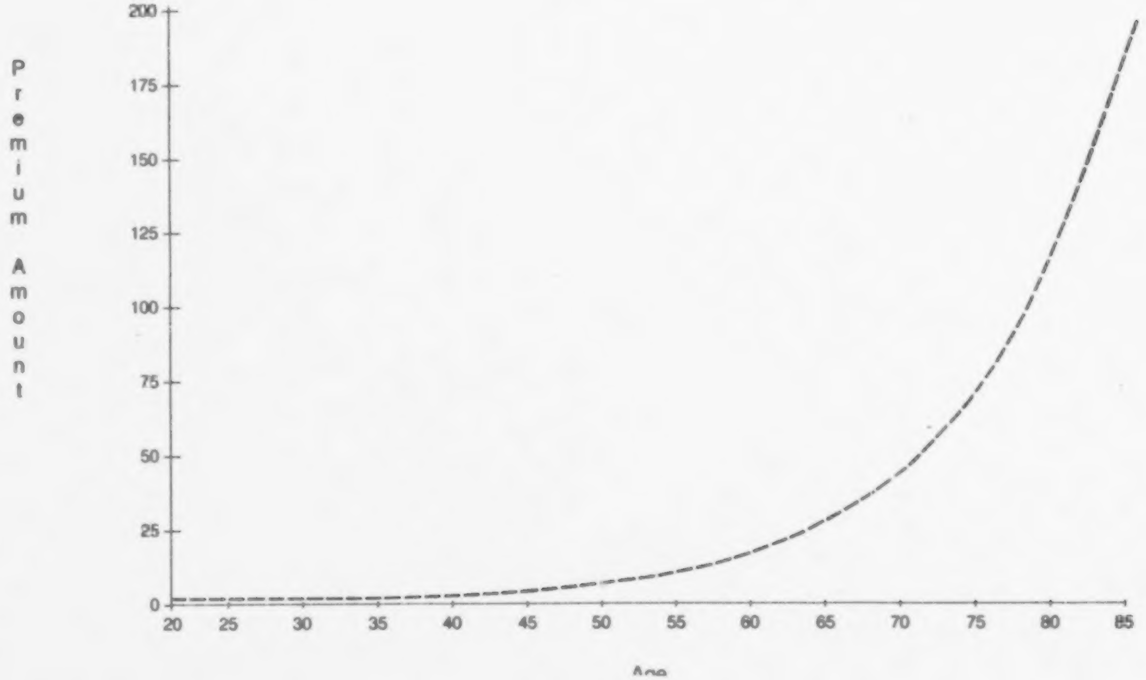


CHART 2
Premiums Per $1,000 of Insurance
Insured Age 35

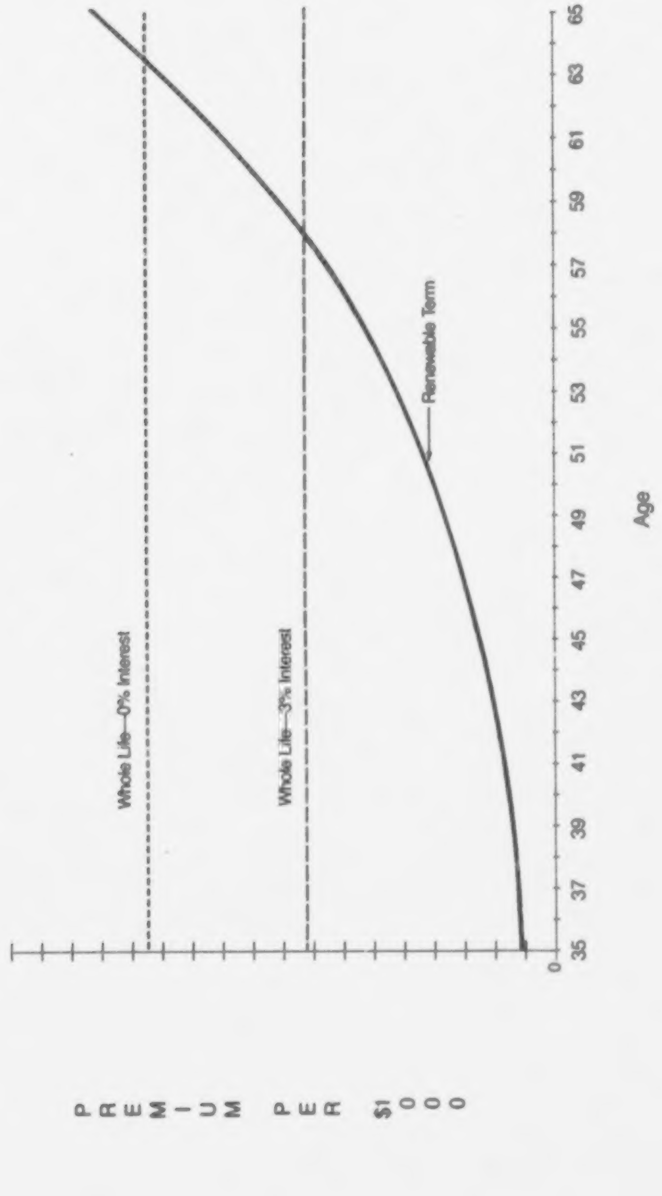
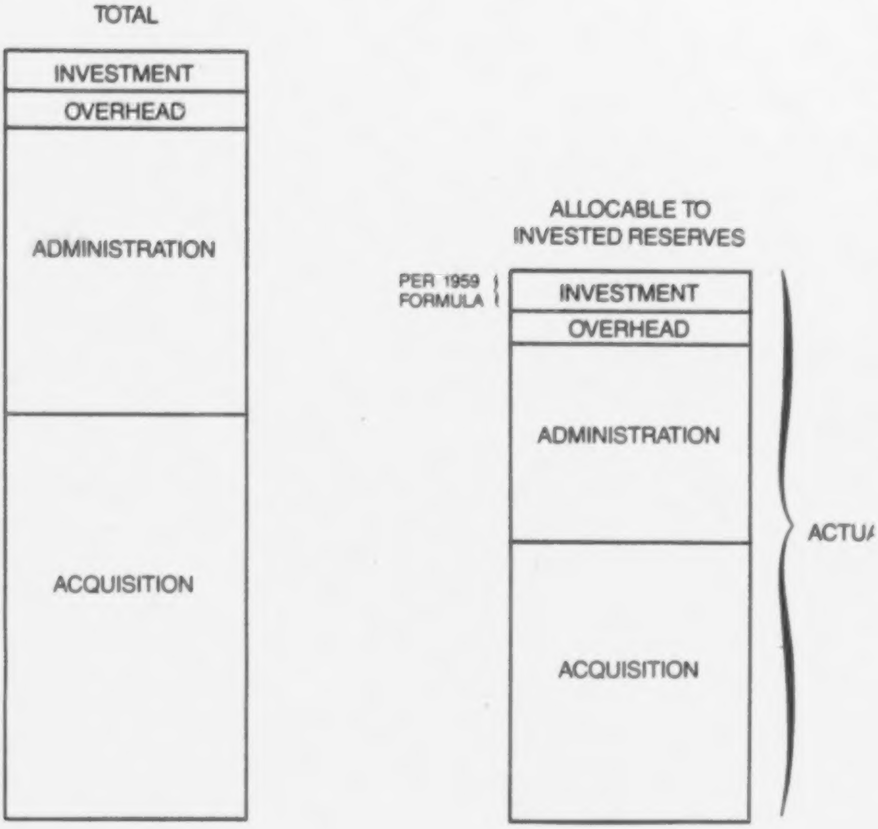


CHART 3
Individual Life Expenses


TOTAL
INVESTMENT
OVERHEAD
ADMINISTRATION
ACQUISITION
ALLOCABLE TO INVESTED RESERVES
PER 1959 FORMULA
INVESTMENT
OVERHEAD
ADMINISTRATION
ACQUISITION
ACTU

Based on 1982
Equitable Life Results

CHART 4
Alternative Approaches to Measurement of Investment Income Available to Individual Life and Annuity Contracts

Indirect Approach

+
Gross Inv. Inc. (E)
– Corp. Pen. Inv. Inc. (A)
– Group Inv. Inc. (A)
– Health Inv. Inc. (A)
– Ind. Pen. Inv. Inc. (A)
– Inv. Inc. on Capital (A)

–
Total Expenses (E)
– Corp. Pension Expenses (A)
– Group Expenses (A)
– Health Expenses (A)
– Ind. Pension Expenses (A)
– Other Ind. Ins. Exps. (A)

– Base Interest Credit (C)
– 1099 Reports (E)

Direct Approach

+ Cash Values Recd or Credited (E)
+ Dividends (E)
+ Term Insurance Benefits (C)
– Premiums (E)
– Base Interest Credit (C)

Chairman **Stark**. Thank you. Let me see if I can tie together a couple of ideas relative to your summary. You are suggesting that we ought to somehow, in a definitional way, describe policies that ought not to qualify for insurance tax treatment.

Mr. **Garber**. That is right.

Chairman **Stark**. That gives us a problem regarding jurisdiction. In other words, if we now throw out a certain group of policies that don't qualify under 101(f), you then say well, then you don't get the death benefit to passthrough. But then you get a whole different bunch of calculations on early termination. And if you have 85 letter rulings stewing downtown, you are never sure what happens.

Also, there is this remote danger, which I keep bringing up, that we get into the business of doing something other than tax. If we are going to provide for the assurance that these benefits are going to get paid to the public, we take onto ourselves some oversight responsibilities that I don't think we want, and I know the industry doesn't want.

So somehow there was a feeling that if, through the Tax Code, in allowing a certain amount of what is called an inside buildup to pass tax free, that you almost then, by definition, and it also relates to an interest rate some amount of cash value or inside buildup relative to protection, you just kind of have a neat formula that competition pretty much—somebody can indeed sell a universal life product, but at some point the advantage to the investor, and particularly in large amounts where there might be an area for excessive tax sheltering, it just becomes uneconomic to the sophisticated to move that way.

I guess that is all we were attempting to do, and it may be that it will be too simplified to work, but it seemed to us if we could determine just how you would tax this buildup, we might do a better job.

Mr. **Garber**. You are looking for a continuum here, as the mathematicians would say, and I think we would also favor a continuum. I think the question is if you make a definition and the contract then runs outside that definition, what do you do with it?

Chairman **Stark**. As long as there is a tax toll taken in the process somewhere, you say go ahead and sell all you want.

Mr. **Garber**. I think one of the ideas would be that if a contract runs outside, that it is still a life insurance contract, but to the extent it is running outside, it now has a different tax treatment of that particular part of the reserve. That would be one way of continuing a continuum there without having an untouchable contract that now you couldn't deal with in an appropriate fashion.

Chairman **Stark**. Mr. Jenkins?

Mr. **Jenkins**. Thank you, Mr. Chairman.

Mr. Garber, I want to study your testimony a bit further, but basically you are saying that we ought to take the approach suggested by the mutual companies as far as economic income, and try to simplify it in that direction?

Mr. **Garber**. Yes; I think that would be the simpler route in the long term.

Mr. **Jenkins**. Professor Harriss, I want to thank you for your testimony. I think that you brought up some important points regarding the economic benefits and the inside buildup that this committee should take into consideration. Thank you very much for your testimony.

Mr. **Harriss**. Thank you.

Chairman **Stark**. Thank you both. I particularly thank you for your patience. It has been a long day and we appreciate your waiting this long. We want to thank the reporter for her patience.

We will recess until 10 tomorrow morning.

[Whereupon, at 5:40 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday May 11, 1983.]

TAX TREATMENT OF LIFE INSURANCE

WEDNESDAY, MAY 11, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman **Stark**. The Subcommittee on Select Revenue Measures will continue its hearing.

We will begin in a moment the second day of hearings, most of which will be from representatives of stock companies and from interested associations. I think it is important to note, before we begin the second day of hearings, that in much of the testimony there has been made reference to a Stark approach.

The Chair would just note that this committee and its staff, in its deliberations, have had as many approaches as a college freshman in a singles bar. It is difficult for us to know just exactly which is the Stark approach. We are flattered, but at this point calculations on any such approach have been used mainly as an analytical tool, and certainly not as an indication of any predetermined method by which we might plan to change the Tax Code.

Yesterday we were unable to accommodate one of our colleagues, the Hon. Dan Marriott from the State of Utah, and we will begin with him this morning. Dan, welcome to the committee. If you have a prepared statement, it will be made part of the record. You may proceed to summarize or read it in any manner you see fit.

STATEMENT OF HON. DAN MARRIOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. **Marriott**. Thank you, Mr. Chairman. I appreciate the opportunity of comning before this committee, not only as a Member of Congress but as one who has spent a lifetime in the insurance business, both as a salesman and as a consultant.

I suppose I am one of the few Members of Congress who is a lifetime member of the Million-Dollar Roundtable, ACLU, and I have been a general agent for many life insurance companies, stocks, mutuals, big ones and little ones, and my associates and I over the years, Mr. Chairman, have placed millions of dollars of life insurance, par, nonpar, universal life, excess interest contracts, direct recognition, and, yes, Mr. Chairman, even I think you will be happy to know we have written a lot of term insurance and invested the difference.

I have a lot of confidence in the life insurance industry, and I believe this is in the best interests of this country and this committee to promote life insurance and savings in all of its forms as a social responsibility.

What I would like to do in just a few minutes allotted to me today is make some recommendation that I hope the committee will consider.

No. 1, Mr. Chairman, I believe that we need to have a permanent taxing bill. Neither the stock gap nor the old 1959 act in my opinion are reasonable. The insurance industry today needs some stability. With the new products coming on line which are incentive, we need to have a certain degree of continuity. That is nonexistent.

Mr. Chairman, the No. 1 priority as far as I am concerned of any taxing bill needs to be the policyholder, not the companies, not the stockholders, not the big companies or the little ones, but the policyholders. There should be in my opinion no preferential treatment, no differentials, no favoritism, no special deductions, no loopholes. There should be no attempt to help some by penalizing others.

If there are to be any rewards from a taxing policy, those rewards should be accrued to the policyholders and to the beneficiaries. Stockholders in my opinion must only benefit from prudent investment of capital contributions, and efficiency of operations, not at the expense of policyholders, and tax policies should not in any way be aimed at guaranteeing profits for any company. The policyholder, the consumer of life insurance, must be our No. 1 priority. Unfortunately, today the same products have different tax consequences. This is wrong, and distorts the marketplace.

No. 2, I believe that we need to end the abuses that are taking place in the industry, and there are abuses under 818(c)(2). That is, we need to redefine, Mr. Chairman, what is life insurance and what is term insurance. To me it is ridiculous to have a company issue a term insurance policy with a $2 per thousand premium, which is intended to be term, which will always be term, which is never going to convert to ordinary life, and then to give that company a $19 per thousand tax deduction.

There is something wrong with that. I am not in favor of ending 818(c)(1) or (c)(2), but I think we have to redefine to what it applies.

I believe, Mr. Chairman, that we should allow a $5 per thousand deduction on term or a $19 per thousand on ordinary life only if the first year's gross premium exceeds the first-year cost of insurance, and to get a $19 deduction we should only do that if we are dealing with a level premium, level death benefit life or endowment policy.

It is time for us in this committee to end the gimmicks—and there are too many gimmicks out there—and companies, I believe, selling those gimmicks hoping they will be grandfathered in. I would suppose that the thing to do is to come out with a tax policy once and for all and to start by redefining what we mean by life insurance.

No. 3, I believe all companies ought to have a 100-percent dividend deduction. If in fact these dividends, or excess interests, or whatever they are called in fact are paid to the policyholders, they should be deemed as in the same line as reserves or other expenses. Anything that goes to a policyholder should receive a deduction.

No. 4, Mr. Chairman, I believe that we ought to consider on this committee taxing life insurance company investments like banks and other corporations. For example, on tax exempts, life insurance companies are taxed under the proration rule, where banks are not, which means that companies have no incentive to invest in tax exempts, or little incentive. With the need for capital at the local level and the community levels and in the smokestack industries, I believe considering the changing of this tax law would be helpful.

No. 5, I believe, Mr. Chairman, we should consider a proxy tax on cash values. My suggestion would be that the committee look at the option of taking the cash values times the current interest rate adjusted for loans, and calling that the amount credited to cash values, and then applying, say, a 10-percent proxy tax across the board. That would apply to all companies. That would produce equities among products and companies. It would raise about $2 billion of revenue from the Treasury, and it would indeed tax all companies equally.

If there are $300 billion of cash values in the industry, and they earn, say, about a 7-percent return, that is $21 billion. Ninety percent of that goes to policyholders, which is about $18 billion. That could result in about a $1.8 billion tax. So I think the proxy tax is something we ought to look at on this committee as a way of equalizing the tax burden.

Finally, Mr. Chairman, my sixth suggestion for the committee to analyze—and, again, I am not giving these as mandates, but hopefully the committee might look at them. I think we have to resolve the ownrship issue between stocks and mutual companies.

I think maybe what we ought to do, Mr. Chairman, for tax purposes, is demutualize the mutuals. That is what is wrong with reclassifying a percent of the premium that mutuals pay as a capital contribution, and then reclassifying a percent of policyholder dividends as shareholder dividends and then requiring stock companies to pay, actually pay a shareholder dividend or to be taxed as if they did.

It seems to me, Mr. Chairman, that this approach, or something like it, would remove the differential between co-ops, mutual companies or co-ops, and stock companies which are capital contribution companies.

Again, Mr. Chairman, if I have to be an advocate for anything, I would be an advocate for the policyholder, and I would hope that tax policy could be equalized so it benefits the tax policyholder, and that all companies are treated equally when it comes to taxation.

I thank the chairman for giving me the opportunity of making these points.

Chairman **Stark**. Thank you very much, Dan. I have just a couple of questions. One, for the record, have you and I ever discussed life insurance taxation?

Mr. **Marriott**. Mr. Chairman, you and I have never discussed anything, as I remember.

Chairman **Stark**. Also for the record, have you discussed life insurance taxation with Secretary Chapoton or any member of the Treasury Department or the Internal Revenue Service?

Mr. **Marriott**. Mr. Chairman, I have not discussed life insurance with anybody at the Treasury Department insofar as I am aware.

Chairman **Stark**. Or with anyone on the staff of the Joint Committee on Taxation?

Mr. **Marriott**. Mr. Chairman, at this point I am hoping to get an interview with the brethren of the Treasury and express my points of view to them. At this point I have not discussed it with anybody.

Chairman **Stark**. All I can say in that regard is that it is interesting when the great minds of the world are traveling in the same direction.

I welcome your testimony. I think that you, the Treasury and the committee staff share many of the same ideas. I personally hope that you will continue to share those ideas with us because you obviously have a broad understanding of the issues that this committee faces. You have had the advantage over most of us of working with these issues for a long time, and we have been trying over the past several months to play catchup.

It is refreshing to hear somebody on the inside of the industry suggest that there are new ways to look at this, that there are fair ways, and that there is a way to level the playing field. I appreciate it.

I will be very interested in reviewing your testimony in more detail and perhaps having a chance to work with you later on the refinement of the ideas you have presented.

Mr. **Marriott**. I would welcome that, Mr. Chairman.

Chairman **Stark**. For the audience here, we operate in this committee under a Gibbons rule: We don't always recognize the committee members in order of seniority, but in order of attendance, because oftentimes we don't get anybody here unless we do that. So, under that rule it is a wire finish on the minority side, but I will recognize at this time Mr. Schulze.

Mr. **Schulze**. Mr. Chairman, I just want to thank our colleague for a very interesting presentation, and I have no questions.

Chairman **Stark**. Mr. Dorgan.

Mr. **Dorgan**. No questions.

Chairman **Stark**. Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman, and thank you, Mr. Marriott, for sharing your expertise with us. Obviously you know the industry. There seems to be great intensity in the competition between the mutuals, stocks, and small stocks. You ended your testimony by saying that you think everybody should be taxed equally.

With your knowledge, do you think there is any tax that we could impose that might make it impossible for one of these groups to really compete as they do today? Do you see this as a danger as you have watched the progress of these hearings?

Mr. **Marriott**. Congresswoman, I think that is a real problem. The stock companies certainly have two dimensions. They have to pay policyholders and pay stockholders. I am not sure what they pay stockholders, however, to influence the policyholders, but it does.

The mutual companies pose another dilemma. Who actually owns the mutual companies? I frankly don't know that myself. We hear the policyholders own them, and therefore policyholders should be partly taxed as stockholders. I don't believe that to be the case, but it does pose some interesting questions for the committee to ponder.

I believe the recommendations that I made at the end of my testimony, or some ramification of that, could solve that problem. I think if this committee can resolve the ownership issue, and set up a taxing schedule that is fair to both, by reclassifying some of the premiums for mutual companies, that mutual companies collect as capital contributions, and reclassifying some of the shareholder, policyholder dividends as a shareholder dividend in a simple formula, that could put that issue to rest.

If we could resolve that issue, I believe we could tax all of the companies, big and small, without any problem, and we could indeed foster competition throughout the industry, and I believe that competition is the key word.

I think we cannot provide through a taxing policy any economic benefits to anybody. I passed this idea on to some small stocks, some big stocks, and some big and small mutuals. All of them think it creates a basis from which we could find a consensus. I think that is going to be the big issue, though, in terms of coming out with a taxing policy.

Mrs. KENNELLY. Thank you, Mr. Marriott.

Chairman STARK. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I thank our colleague. Your expertise is perhaps as great as any other Member that I know in the House. Let me ask you a question. Are the policy rates pretty much the same for stock companies and mutuals? Is there a difference in the price?

Mr. MARRIOTT. It depends on the premium type of policy, Mr. Duncan, but as a general rule the mutual companies are charging a premium as high as 120 percent above the stock company premiums. The mutual companies do that because they do not take in capital contributions.

The stock companies take in premiums as well as have capital. The mutuals only have premiums, and as a result charge more to offset in some degree the capital contribution, so it is true that most mutual companies that I have dealt with have a higher premium of 10 to 20 percent above what you could buy a fixed cost nonparticipating policy for.

Mr. DUNCAN. How would the payout from the mutuals compare with the dividends from the stock companies? Would you have any knowledge of that?

Mr. MARRIOTT. Well, from the policyholder's point of view, a nonparticipating policy issued by a stock company does not pay a dividend. All the benefits are fixed in the contract, and with a mutual company, they charge a higher premium, they have their fixed benefits, and then they pay a dividend on top of that.

Stock companies are now producing participating policies, and now with the new policies, universal life, companies are paying a fixed benefit, and also excess interest or dividends above that. That is being done by both stocks and mutuals.

If you look to the participating policy on a long run and a nonparticipating policy on the long run, the participating policy would be a better deal for the policyholder, assuming that the companies paid the dividend that they claimed they are going to pay. Now, some of that is attributed to the excess premium that is collected by the mutual company as well.

Mr. **Duncan**. Group insurance is sold on a competitive basis business. Do you find that smaller companies pay larger premiums in group insurance than the larger companies?

Mr. **Marriott**. Do they offer?

Mr. **Duncan**. The premiums for group insurance of smaller companies, do they pay more or less than the larger companies?

Mr. **Marriott**. I have found in group insurance—we are talking about group life insurance, I assume?

Mr. **Duncan**. Yes.

Mr. **Marriott**. In group life insurance, which is for the most part term insurance, I found small companies to be just as competitive as big companies on their premium rates.

Mr. **Duncan**. What about the health and accident group?

Mr. **Marriott**. In some cases small companies can be even more competitive than big companies on health and accident.

Mr. **Duncan**. Is the premium based upon the rate of the payout?

Mr. **Marriott**. For the most part it is based on their experience.

Mr. **Duncan**. Experience.

Mr. **Marriott**. With premiums, their premium and claims ratios, their profit margins and so forth, but as a general rule that is based on experience.

Mr. **Duncan**. Thank you again. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

Dan, I appreciated your testimony very much. I have a question I would like your judgment on. The insurance industry exists for many reasons—risk, capital accumulation—many functions among others. The tax incentives that are granted encourage the industry to perform these functions. Do you think that they are performing these functions in the most efficient manner.

I am really interested in whether or not you think there is some way that this committee might provide further incentives to the insurance companies to more efficiently carry out their role. In particular, you emphasize the policyholder. Are the demographics changing? Are the needs changing that the industry is trying to address, and can we make a positive contribution to more effectively assist the industry in achieving essential public policy goals.

Mr. **Marriott**. Yes, Mr. Flippo. I would say that the Government in some way has been a problem for the insurance industry. Taxing policy has left a lot of confusion out there as to what exactly is happening. I gave you an example. Today we have for stock companies, on dividend deductions they get a 75-percent dividend deduction, mutuals get a 7½-percent dividend deduction. Some companies' projections on their current earnings are in some degree based upon what those deductions are.

Many companies are taking 100 percent dividend deduction in hopes that you will grandfather them in once we get our act together, and so all of this has an effect upon what the policyholder sees on this nice proposal sheet that agents make for them.

So I think the Government having a policy of uncertainty, and Treasury to some degree wavering on their private rulings, has left a lot of confusion, and so companies are doing different things and taking advantage of that confusion. So from my point of view, we have to get our act together, and once and for all determine what we mean by life insurance, and how we are going to tax it and tax it fairly once and for all. To me that is the most important thing.

As far as the insurance industry goes, any incentive that we can give for people to save and invest and accumulate capital is good, so I think what this committee has to do is erase the loopholes and get rid of the gimmicks and have the companies cooperate in that and develop a system that indeed makes a life insurance policy more attractive. They have come a long way.

The new universal life policies, the new jumbo dividend participating policies are much closer now to the old concepts of buying term and investing the difference. The yield to the policyholder is much better. It seems to me that we can solve a lot of governmental problems, and maybe even welfare problems, by making life insurance simpler and cleaner and more attractive to the consumer.

Mr. **Flippo**. I thank the gentleman for his response.

Chairman **Stark**. Mr. Jenkins.

Mr. **Jenkins**. I have no questions.

Chairman **Stark**. Dan, if I could ask one last question. One of the things that we will be hearing testimony on today, and one of the ancillary problems in the nature of universal life and jumbo dividends, are deferred annuities. As I understand it, there really is no insurance risk when you start making the payments.

I gather that the risk is perhaps during the buildup period, but you or I could save for an annuity in a savings and loan or buy accumulating series E bonds where there would be no tax. But there is a governmental purpose for the tax-favored treatment of a series E bond or a municipal bond: We get tax-free savings because we help municipalities.

The companies will testify that if we attack any of that buildup in the deferred annuity as people are saving for it, we will put them out of business. The more direct testimony will suggest that they are basically selling a tax shelter.

Do you have any feelings on what would be fair?

We really don't want to put anybody out of business, but on the other hand I don't think Government is in the position of creating a tax-free climate for one industry and not for the other. How do you tell the savings banks, then, that they can't have tax-free buildup in a long-term CD?

Mr. **Marriott**. In all candor, Mr. Chairman, life insurance should be bought, even universal life products should be bought as a long-term investment. If a person simply wants a short-term investment, he should buy term insurance and put the difference someplace else. So if we can encourage people to save in the long term, then I believe the inside buildup advantage should be maintained. On the other hand, Mr. Chairman, my idea of a proxy tax on the earnings of cash values really equalizes that issue.

Chairman **Stark**. So you would say your proxy tax should apply to the buildup on a deferred annuity, just as it would on a whole life policy?

Mr. **Marriott**. I think you should consider that.

Chairman **Stark**. Thank you. I want to repeat that yours has been excellent testimony, and I appreciate your taking the time out of your busy schedule. I apologize for our scheduling problem yesterday.

Mr. **Marriott**. Thank you very much, Mr. Chairman.

Chairman **Stark**. Our next witness will be a panel, the National Association of Life Underwriters, represented by Thomas Gregg, chairman of the committee on Federal law and legislation, and the Association for Advanced Life Underwriting, Mr. Fred R. Kissling, Jr., CLU, and president of that association. Welcome to the committee.

We are going to ask each of you to summarize your written testimony which will appear in the record in full, in addition to your summary. The members have had a chance to read your testimony, and we will give you a chance to elaborate in more detail in response to the committee's questions.

Mr. Gregg, would you like to proceed to summarize your statement.

STATEMENT OF THOMAS GREGG, CHAIRMAN, COMMITTEE ON FEDERAL LAW AND LEGISLATION, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, ACCOMPANIED BY H. JAMES DOUDS, SENIOR VICE PRESIDENT AND GENERAL COUNSEL

Mr. **Gregg**. Thank you. My name is Tom Gregg, of Life Underwriters, from Topeka, Kans. I am here today representing the National Association of Life Underwriters, an association of a little bit over 125,000 life insurance salesmen from all over the United States.

Our membership is almost evenly split between stock and mutual companies. I am chairman of the Federal L&L committee of NALU. With me this morning, on my left, is Mr. James Douds, who is senior vice president and general counsel of NALU.

The bulk of the subcommittee questions were directed toward company tax provisions. We do not believe it is appropriate for us to comment in any length on this issue. We must say, however, that as a general rule, the Tax Code should be neutral as it applies to companies and to company products.

In our prepared statement we have outlined the history of cash value life insurance. We state that life insurance is not an investment as the term "investment" is used by the subcommittee in posing its questions. The product we sell to America's businesses and wage earners is unique in that it is almost the only source of financial security that is available to widows, to families of wage earners, to spouses, and to the heirs of small business. Permanent life insurance is a financial tool used to protect against the economic consequences of dying too soon or living too long.

In a true investment, the investor assumes the risk. When one buys a permanent life insurance policy, he transfers that risk.

The company, in assuming the insurer role, carefully invests premium dollars in long-term bonds, mortgages and securities, so that regardless of when death or retirement eventuates a guaranteed amount will be available for delivery.

The benefit to our economy resulting from the huge flow of capital is incalculable. We suggest that no changes should be made in the mistaken belief that life insurance is an investment.

I could easily double or triple the length of my testimony with examples of the miracle of life insurance. Suffice it to say that this country has counted on life insurance for over 200 years. The miracle has never stopped working. As long as people eventually die and/or get old in the process, there will always be a need for permanent life insurance.

Congress since 1921 has recognized this social value of life insurance, and has encouraged the use and purchase of insurance. The historic tax treatment we depend on should be continued so that permanent life insurance purchases are not discouraged in the future.

In 1981 over $12 billion was paid to retirees from the values of their permanent insurance policies. To a large degree, permanent insurance with its concomitant reserve values lessens this country's reliance on the social security system, and hence helps assure adequate retirement levels for our older citizens. Private funds may well turn out to be the only bulwark against future social security benefit reductions.

Congress has just taken a positive action that we hope will be but one of several steps necessary to bolster the social security system. We are told that we can again count on social security and the promises that system makes. Having just put this one to bed, so to speak, this is hardly the time to discourage people from planning for their future by taxing the inside buildup in life insurance.

Additionally, the historic tax treatment afforded permanent insurance has been used primarily by average middle-class Americans. We have offered several examples of analogous purchases that are not taxed. When a family purchases a home and that home experiences an increase in value, the homeowner is not taxed on the increase. There has been no constructive receipt of any income.

Similarly, the purchase of a diamond at the time of engagement never creates a tax problem for the owner, just because an increase in value is experienced. Even though each item has a well-recognized appreciating inside buildup, none of the three was bought for that purpose. The ring was bought for marriage, the home for shelter, and life insurance for protection and for security.

Many studies show that less than 1 to 2 percent of all term policies sold eventuate in a death claim. It is permanent insurance that finally results in death claims. The typical life insurance policy may stay in force for many decades. To make it work, the Government must provide a framework of stability during good times and bad.

Right now these times are good, not quite as good as they were 6 months ago or 1 year ago, but business is generally good and interest rates are going down. In the long run this benefits everyone and has a tendency to become a great equalizer. If we heed our best instincts, it might not be too long before interest rates sink to pre-1981 levels.

Will we then be paying too much interest or will too little interest again be the issue? There are many legal and social justifications for today's tax treatment which are historical in nature. The 62-year-old provision in the Internal Revenue Code allows for this historic treatment.

We ask that you also consider the tremendous impact on life insurance company administration, and the cost of insurance to the buyer if reports of increases and accumulations in cash values have to be rendered to policyholders for tax purposes.

We encourage Congress to maintain the status quo so that this great industry can continue to make and guarantee long-term promises and commitments knowing that those promised funds will be available for guaranteed delivery.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. Chairman and members of the Subcommittee, I am Thomas M. Gregg, from Topeka, Kansas. My business, like that of many thousands of life underwriters across the country, involves the sale and service of life and health insurance policies to and for individuals, groups and businesses, especially small businesses.

I am appearing here today as the representative of The National Association of Life Underwriters, which is a federation of over 1,000 state and local life underwriter associations. The federation represents a combined total of some 126,000 career life underwriters who, in turn, represent both stock and mutual life insurance companies.

As a matter of fact, at the moment the 126,000 individuals comprising the membership of the federated associations are almost equally divided between stock and mutual companies. From that essentially equal division, our position on the taxation of life insurance companies would appear to be evident, i.e., we believe the tax laws should be so designed as to competitively favor neither stock nor mutual insurers.

Beyond that, we do not presume to comment on apropriate life insurance company taxation, except to say that life companies should not be called upon to pay more than their fair share of corporate taxes, and to note that life insurance companies pay significant state premium taxes that should be taken into account in any proposal to increase federal taxes with respect to them.

Our statement, therefore, addresses the issues raised in Subcommittee Press Release No. 3 under the heading of "Policyholder Taxation." We will comment particularly on the issues raised in the first two of these questions: (1) the historical or social justification for tax deferral on the policyholder level of the inside buildup, or cash values, of permanent insurance policies; and (2) the extent to which this current tax treatment should be continued. The course of our comments on these questions will inevitably touch on many of the other issues presented by the subcommittee in its announcement of these hearings.

THE HISTORICAL TREATMENT OF CASH VALUES WAS SOUNDLY CONCEIVED

Cash value life insurance developed out of the desirability if not the necessity of providing a level premium for the duration of a life insurance contract. The vitality of the level premium has been described as follows:

"The chief significance of the level premium concept lies in the fact that the redundant premiums in the early years of cash value contracts create a fund which is held by the insurer for the benefit and to the the credit of the policyowners. Earnings (principally interest) are produced by investing the fund. The accumulated fund, improved by earnings, is used to pay out the benefit amounts provided for under the contract. Thus, the level premium is the only arrangement under which it is possible to provide insurance protection to the uppermost limits of the human life-span without the premium per unit of face amount increasing as age advances and eventually becoming prohibitive for most individuals." [Life and Health Insurance Handbook, 1973]

The cash value is primarily an incident of the reserve required by law to support the promise to pay at a later time, having its origin in the excess premiums charged in the early years of the contract to keep the premium level over the life of the policy.

In fact, it used to be that policies contained no provision at all for the payment of amounts representing an insured's equity on termination prior to the maturity of the policy. The law did not generally require policies to have a cash value until after the turn of the century. Cash values, rather than being 'savings' or 'investment' in concept, grew out of public policy against full forfeiture upon lapse and the desire to establish a basis whereby the purchaser, on early termination, could recover some of the payments already made. Nonetheless, the cash value buildup of a permanent life insurance policy has long since been recognized as serving a socially-desirable savings and investment function, in addition to providing a means whereby level annual premium products that can stay in force at upper ages may be offered by an insurance company.

Indeed, the savings aspect of permanent life insurance does engender benefits in addition to the primary benefit to be derived from purchasing cash value life insurance—the preservation of the economic human life value of the insured for his beneficiaries. The savings feature of cash value life insurance also affords purchasers such additional valuable features as policy loans, automatic premium loans, and extended term insurance to prevent lapse, and the right to purchase annuities in accordance with policy settlement options. In addition to providing a guaranteed face amount, the cash value life insurance policy has thus evolved into a contract embodying a significant bundle of ancillary rights, none of which can really be said to predominate in importance over others.

WHY PERMANENT LIFE INSURANCE IS IMPORTANT TO SOCIETY

Permanent family protection

Cash value life insurance with its non-escalating premium can be fully relied on to provide more durable coverage.

It is not our intent to denigrate term insurance, but only to show the unique value of permanent insurance in society. To illustrate, a 1983 study conducted by Arthur L. Williams, head of the Pennsylvania State University's Department of Insurance and Real Estate, reveals that less than 1% of all term insurance results in a death claim, and the numer of death claims paid on term insurance is declining. Professor William's study also reveals that only 1.5 term policies in 10 persist to the end of the period for which they were written, and only half of the term policies written are converted to other forms of insurance. [Williams, "Term Life Insurance: Revisited" (1983)]

Any life underwriter could furnish examples of how permanent insurance has worked to provide security where term insurance would have failed. To take just one example: a 40-year-old advertising man died in California last February. This man owned over $100,000 of permanent life insurance. His policies had been in force for over ten years. He owned his own advertising agency and, like many other small businesses, his agency had recently been hit hard by the recession. As a result, he did not pay his life insurance premiums. But, his policies were on automatic premium loan because their cash values were, under the terms of the policy, automatically called upon to provide extended term insurance. Consequently, when he was killed in a car accident, his insurance was still in force. The policy proceeds shielded his wife, who has never worked, and his seven year old daughter from financial devastation. Had he purchased term insurance, the coverage would have lapsed without value.

Retirement security

The social value of permanent forms of life insurance is also found in its contribution to the general financial welfare. Just two months ago the Congress enacted so-called Social Security refinancing legislation made necessary by the rapidly deteriorating financial condition of the nation's own retirement system. It was even predicted that funds would not be available this coming July to pay benefits on a timely basis.

The legislation itself has a long and complicated history and required extraordinary political statesmanship on all sides in order for it to be enacted. One of the lessons the Congress and the public, too, seems to have learned in the process is that the Social Security system, while necessary and desirable, cannot expand indefinitely without dire financial consequences in the form of reduced funds for all other purposes. There is only so much cash in this Country with which to pay retirement benefits. The Social Security system certainly cannot provide all, or even most, of the income security needs of people. Yet, those income security needs exist and somehow must be met.

Life insurance, both temporary and permanent, plays a most vital role in meeting the income security needs of people, and by doing so reduces the pressure on the Social Security system to provide ever higher and broader levels of benefits than those already in place. Both permanent and term insurance provide benefits for survivors of breadwinners. Only permanent forms of insurance, however, provide survivor benefits at more advanced ages, as well as retirement benefits for breadwinners at retirement.

In view of the troubled financial state of Social Security during the last decade, this is not the time, in our judgment, to do anything to discourage people from acquiring permanent insurance. The decisions that might be made today which would have that effect won't show up as adverse results for many years. And, the Congress well knows the difficulty of projecting the future financial position of Social Security, try as it might. If, as some Social Security experts suggest, the long-range projections are off by only a small percentage, huge shortfalls in revenue may result.

Private funds may then be the only bulwark against future Social Security benefit reductions. It would be catastrophic if tax policy-induced cutbacks in the retirement benefits of permanent insurance began showing up at the same time.

Investment capital

Taxation of the increasing cash values of life insurance would depress a proven source of needed investment capital. In 1981 alone, life insurance companies provided an additional $38.3 billion for investment in the economy of the country. To walk through a life insurance company's investment department is to walk down Main Street in most cities and towns in America. The telephone wires reflect investment in utilities; the shopping mall with its dozens or hundreds of jobs was financed at least in part by mortgages held by life insurance companies; housing construction is possible through resources held by life companies. As evidence of life insurance company assets at work, we have attached a Federal Reserve Board chart showing 1980 corporate bond investments of $200 billion; mortgages of almost $140 billion; and corporate stocks of over $40 billion.

These primarily long-term investments are largely made possible because millions of policyholders are willing to commit themselves for long periods of time to cash value life insurance. According to the 1982 Life Insurance Fact Book of the American Council of Life Insurance, in 1981 life insurance ranked fourth among private domestic institutional sources of funds, supplying 8.5 percent of the total funds flowing into financial markets.

Taxation of funds attributable to policyholders would surely dilute this pool of capital if it would in any way discourage the purchase of cash value insurance because, as compared with term insurance, substantially all of the investment capital derived from premiums comes from cash value life insurance premiums. The American Council of Life Insurance (ACLI)—made up of 572 life insurance companies—has said that, "Term insurance premium availability for investment is negligible." [ACLI Submission to the Secretary of the Treasury, W. Michael Blumenthal on a tentative Carter Administration Proposal to Tax Policyholders on the Interest Element of Life Insurance Contracts, Aug. 25, 1977, at p. 5.]

THE HISTORIC TAX TREATMENT OF CASH VALUES SHOULD BE CONTINUED

Efficient tax administration requires historic treatment

"Taxation" has been characterized as "operating upon a community, or upon a class of persons in a community, by some rule of apportionment." Again according to the Life Insurance Fact Book, there were 150 million individual policies in force in the United States in 1981. Sixty percent of these—about 90 million—were cash value policies.

If a rule were to be adopted apportioning a tax on policyholder cash values, consider the tremendous impact on life insurance company administration and on the cost of insurance to the buyer if reports of increases and accumulations in these cash values had to be rendered to policyholders for tax purposes.

Consider also the additional expense and compliance burden to be borne by millions of policyholders due to the administration, reporting and collection of a tax on policyholders cash values.

Life insurance is not primarily an investment

We readily acknowledge that life insurance is part investment. As a matter of fact, this has nearly always been true. As early as 1911, Mr. Justice Holmes stated the opinion of the U.S. Supreme Court that ". . . life insurance has become in our days one of the best recognized forms of investment and self-compelled saving." *Grigsby* v. *Russell,* 222 U.S. 149, 156 (1911). We only contend that life insurance is not an "investment" as that term seems to be used by the Subcommittee. The investor assumes risk; the insured seeks to transfer it.

In our opinion, life insurance should instead be viewed as a unique mechanism by which financial security is assured; the cash value serves the purpose of keeping the premium from becoming prohibitive with the insured's advancing age. Thus permanent life insurance has been recognized by Congress for over 60 years as a financial tool of such social value that its acquisition merits the encouragement it has received through its historic federal tax treatment.

Cash value life insurance does have as a byproduct a savings, or, as some call it, an investment element, and in recent years this aspect of life insurance has attracted much added attention because of unprecedented high interest rates. But this may be considered an aberration. As interest rates have begun to settle down toward more traditional levels, "investors" recently attracted to cash value policies by high interest rates have already begun to turn away toward other products for their "profits," because any "investment" element of cash value life insurance remains indeed only a byproduct, notwithstanding this recent increased emphasis placed upon it. That life insurance as well as other products have become better investments in response to high interest rates and continued inflation has no essential relevance to the basic nature and long-term use of a life insurance policy, or to the underlying reasons for its purchase.

The recent drastic and prolonged inflationary trend of the United States economy has led to a massive restructuring of the financial services sector of the economy. Clearly, the focus of many consumers has turned from goals of achieving steady growth of capital in a relatively inflation-free society to a mad rush to obtain the maximum interest rates possible by investing in high-yield, short-term financial depository accounts and products. This development is a direct result of inflation.

This inflation has left consumers confused and frightened, and many have responded by redirecting their investment objectives generally toward short-term, high-yielding financial products and services. Of all financial products, inflation actually hits the life insurance product the hardest, because the amount of income protection afforded under life insurance policies rapidly diminishes as inflation is prolonged.

Additionally, policyholders have in recent times been advised by many financial columnists to borrow against their cash value policies (at traditionally low policy loan rates) and to invest the money in high-yield, short-term depository instruments or money market funds.

The resultant drain on life insurance industry resources and the accompanying problems are well summarized in an excerpt from testimony submitted to the Massachusetts Legislative in February of 1981 by the Life Insurance Association of Massachusetts.

"High inflation and tight credit during the 1979–80 period . . . created unprecedented policy loan activity. For example, a survey of five of the largest Massachusetts companies indicates that between 1976 and 1980 the dollar amount of policy loans outstanding increased by 65.68 percent. A substantial portion of this increase occurred in the last two years. In fact, in 1979 and 1980, the rate of growth in the amount of policy loans for these five companies more than doubled the rate of growth of other assets.

"As a result of the most recent acceleration in interest rates, almost any investor could obtain a return of more than 17 percent in the money market. Consequently, many owners of larger policies borrowed on their policies at interest rates of 5, 6 or 8 percent and reinvested the money at considerably higher rates. This caused a substantial cash drain and severe liquidity problems for many life companies. Some companies were required to raise funds through the sale of securities from their portfolios, often at substantial losses."

As a matter of fact, according to a study of the National Bureau of Economic Research [Warshawsky, "Life Insurance Savings and the After-Tax Rate of Return," Working Paper No. 1040, Dec. 1982], the relative place of life insurance in U.S. household savings has declined, and this decline has accelerated in recent years. Combined with the increased use of policy loans, the net savings through life insurance as a percentage of personal disposable income has been substantially reduced, and such reduction continues. It is a little wonder, then, that life insurance companies, faced with the persistent financial distress created by unprecedented high interest rates, have sought to defend the integrity of the life insurance industry by developing products, advertising rates of return, and taking other action with respect to existing policies which would help stanch the alarming outflow of cash values from many of the traditional insurance products.

Life insurance is purchased primarily as a long-term proposition, to provide adequate protection for dependents of a breadwinner and to permit accumulation of money for retirement purposes. Recent advertising by life insurance companies calling attention to comparable rates of return on life policies as contrasted with short-term savings vehicles offered by banks and money market funds can be viewed as an attempt to safeguard the continued viability of this long-term product as a means for providing financial security to the consumers.

Why tax money the policyholder might never receive?

Under present law, amounts credited to the cash value of a life insurance contract are taxed only when withdrawn and to the extent the withdrawals exceed the aggregate premiums paid by the policyholder for the contract.

Thus, cash values are not current income. Rather, they are merely a measure of an accumulation that the policyholder may, in fact, never realize. They are an accumulation that in most cases will remain only a beneficial interest. It is a long-standing principle of tax law that income is not taxable until it is realized, either actually or constructively.

In the case of life insurance, the United States Tax Court has held in *Theodore H. Cohen,* 39 T.C. 1055 (1963), that the taxpayer's right, prior to the maturity, surrender or sale of life insurance contracts, to receive the cash surrender value of those contracts, including periodic increments thereof, was subject to such 'substantial restrictions' as to make inapplicable the doctrine of constructive receipt. This doctrine generally holds that income is taxable if there is no limitation or condition on the taxpayer's right to bring the income within his control, even if he does not actually do so. The court followed precedent to the effect that there is no constructive receipt of income—hence no taxable income—where one must surrender a valuable right in order to realize it.

Tax liability on the interest earned on cash values would run counter to the doctrine of constructive receipt, creating the inequity, in countless cases—most of them involving millions of middle class taxpayers—of imposing a tax on money never to be received. Bad enough to have to pay taxes to the Government on income; even worse for the Government to assess a tax on money you never get.

As noted in one prominent 1972 study examining the tax treatment of the so-called "inside buildup" (which, incidentally, concedes that this treatment can be justified on social, legal and administrative grounds), the bulk of the advantage of the present tax treatment accrues to middle income families. [McClure, "The Income Tax Treatment of Interest Earned on Savings in Life Insurance," Joint Economic Committee Print, 92 Cong., 2d Sess., May 8, 1972, at 370]. It should not go unstated that the middle income wage earner presently bears an increasingly heavy share of the federal tax load and to impose additional taxes on a means of protecting his or her family against premature death would appear unpalatable from both a social and economic standpoint.

Tax treatment of analogous purchases is an argument for the status quo

On the question of the extent to which various types of life insurance products should continue to enjoy historical tax treatment, your Subcommittee might consider the analogy that appears to exist between cash value life insurance and, say, a diamond engagement ring, or a home.

Each has a "savings" or "investment" element or aspect to it, which might indeed be the subject of considerable enhancement. Should the "inside buildup" in the value of the diamond ring be taxed? Should the growing equity in the home be taxed?

We think that the answer in those instances should be No, and in each case we base our conclusion not only on the non-receipt of the enhanced accumulation by the purchaser, but also on the presumed motivation for the purchase. Even though each item has a well-recognized appreciating "inside" value, none of the three was bought for that purpose, or perhaps even with that in mind. The ring was bought for marriage, the home for shelter, and the life insurance for protection and security.

In our opinion, Congress would have to weigh carefully whether it is reasonable and socially desirable to tax the appreciation in one of these kinds of property without logically taxing the others; or whether, instead, each serves a suficiently worthy social and economic purpose that the historical tax treatment should be left unabridged.

While on the subject of property on which a fair return may be realized, we might also say that it is particularly disconcerting to those who sell and service cash value life insurance to be first attacked by the federal government in the persona of the FTC because life insurance cash value yields are allegedly so low as to amount to "rip-offs," and then, having tried to remedy that problem, to be confronted with the charge that those yields are now so high that they might have to be taxed.

Conclusion

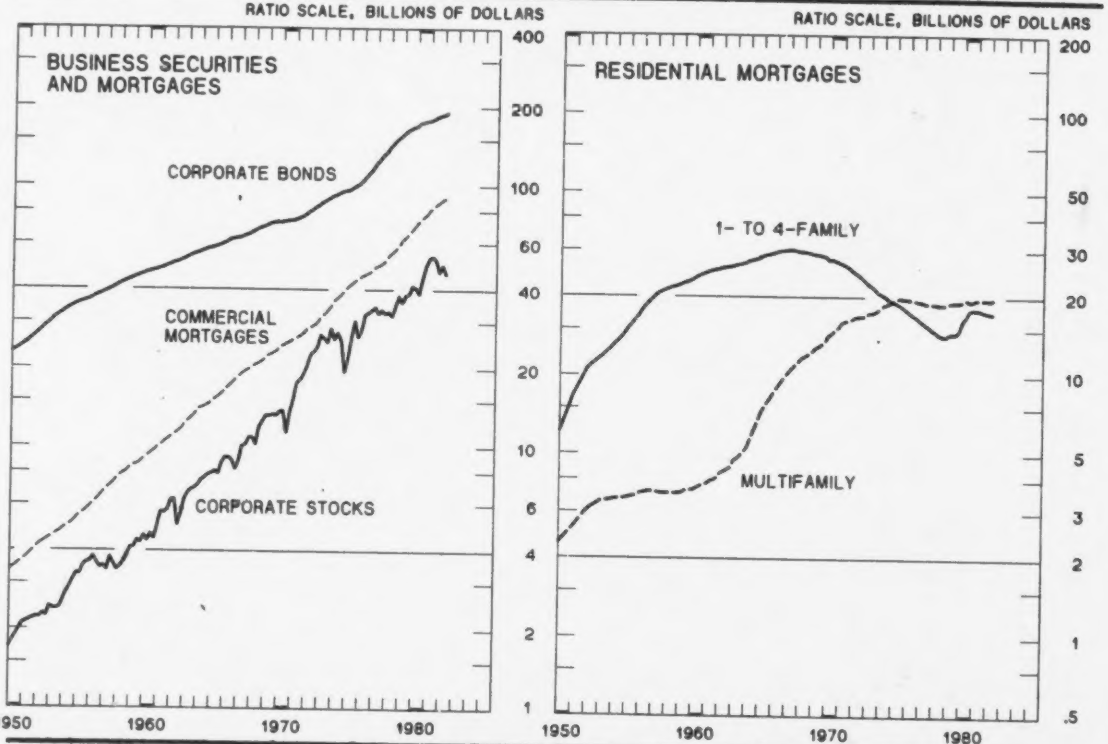
The historical and social justifications for the tax treatment of the cash values in a permanent insurance policy remain persuasive. To the extent that a permanent life insurance policy is purchased to provide long-term protection, and so long as it can be characterized as property whose investment features, if any, are merely a byproduct, it should continue to receive the tax treatment presently accorded it.

Source: Historical Chart Book, Board of Governors of the Federal Reserve System (1982)

PRINCIPAL EARNING ASSETS

LIFE INSURANCE COMPANIES

AMOUNT OUTSTANDING; END OF YEAR, 1950-51; END OF QUARTER, 1952-



Chairman STARK. Mr. Kissling.

STATEMENT OF FRED R. KISSLING, JR., CLU, PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING, ACCOMPANIED BY GERALD H. SHERMAN, ATTORNEY

Mr. KISSLING. My name is Fred Kissling. I appear before you today in my capacity as president of the Association for Advanced Life Underwriting. I am accompanied by Mr. Gerald H. Sherman of the Washington law firm of Silverstein & Mullens.

AALU is a national organization of approximately 1,100 members specializing in one or more fields of advanced underwriting. Collectively, our members are responsible for annual sales of life insurance in excess of $2 billion. We are, therefore, vitally interested in and affected by any change that may occur in the income taxation system which is applied to the life insurance industry.

As agents whose day-to-day activities are concerned with matters of marketing and sales, we are members of a company's field force and have less knowledge respecting its home office. We will, therefore, not offer counsel to you on company matters such as company taxation. However, we do have useful knowledge of the ways in which Federal income taxation of life insurance will affect its availability to the public.

Our written statement, which we request be placed in the record in full, emphasizes this aspect of the subcommittee's inquiry. I will try to be brief in summarizing that statement.

We submit four major points for your consideration:

First, the availability of insured death benefits constitutes a unique economic and social advantage that should be encouraged by the Federal income tax system. In the words yesterday of Assistant Secretary Chapoton, "When a working spouse dies, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living." This, in my language, means that it allows them to live in the dignity of their own world and not have to ask for Federal Government handouts.

Second, a reasonable and fair income tax burden should be imposed on the life insurance company incomes which serve as the source of insured death benefits. As I have stated before, we leave to others in the industry the task of addressing this issue.

Third, the traditional and time-honored Federal income tax treatment of the benefits that come from the life insurance policy in the hands of the policyholder and policy beneficiary should be continued without change.

Fourth, that portion of the Federal tax system which encourages utilization of insured death benefits should not be expanded to contracts which do not have as their primary function the provision of such benefits. Life insurance contracts should be defined to exclude investment vehicles camouflaged as life insurance and to include, with a broad reach, the many and varied forms of traditional life insurance coverage.

In the interests of brevity, I will limit the remainder of my remarks to a discussion of our third major point, that is, the current income tax treatment of the policyholder. This should not be changed.

When the chairman opened these hearings yesterday by stating there was no intention to change the tax rules relating to policyholders and that you were only concerned with matters of company taxation, I breathed a sigh of relief and wondered whether it was appropriate to cancel my appearance before you.

After your first witness, Mr. Chapoton testified, any doubts I had about the relevancy of my appearance vanished. For as long as I can remember—and I have been in the life insurance business for 30 years—the Federal income tax laws have applied to the life insurance policy a constant and well understood system of income taxation, which can be stated as follows:

First, except in certain business situations, the payment of premiums does not result in deduction from income.

Second, accumulating cash values in the policy will produce taxable income to the policyholder only as they are paid out, and only in an amount equal to the excess of the amount of the payment over the premiums previously paid on the policy. The time-honored system of policy loans does not create taxable income in the hands of the policyholder borrower.

Finally, at death, except in certain situations where the beneficiary has acquired the policy after its origination in a transaction involving valuable consideration, the policy proceeds are not subject to Federal income tax. The entire system is applied to tax benefits that are paid out of life insurance company income after expenses and after payment of Federal income taxes at the company level.

Thus in most situations, neither the policyholder nor the beneficiary pays a direct income tax with respect to the insurance policy. Although the benefits received are in an after-tax form, that is, after deduction of Federal taxes paid at the company level, this system has shown itself to be equitable, to be encouraging to the development of life insurance benefits, to be simple enough at the policyholder level so that it is satisfactorily understood by him, and to be totally consistent with the subjection of the industry to such Federal income taxes as social policy imperatives and the dictates of good Federal income tax policy require.

Irrespective of any need that may be perceived for adjustment of the details of the taxing system as applied to companies, no need exists for changing the basic conceptual system or of changing the place in that system where the policyholder for generations has found himself.

We urge you to take no steps that would upset that balance. Any change that would place the instance of taxation on policyholders could easily be perceived by them as a devaluation through the tax system of life insurance generally. This would be true even though the increase in the burden of tax at the policyholder level is offset by a reduction of what would otherwise have been the burden at the company level.

Our focus here is not on what total burden the industry should bear, but on how that burden should be distributed so that it is not misinterpreted or misperceived by the public.

We would be fearful that even such an innocent phrase as "proxy tax" would mislead policyholders into believing that they are not subject to new and debilitating tax burdens. The income tax computed at the life insurance company level is not, and should not be viewed as, a convenient method of collecting tax from the policyholder. It is a corporate income tax and should be recognized as such without additional code word confusion.

We are greatly troubled by Mr. Chapoton's suggestions that withdrawals of cash surrender value, even when made by way of loans, should be taxable to the policyholder out of the first dollars received, to the extent cash value of the policy exceeds the policyholder's investment in the policy, and that in any event, the policyholder's investment in the policy should not include the portion of the premiums determined to be used to pay the cost of term insurance.

These proposals, which may appear to be mere tinkerings with, and minor adjustments of, the tax system, can have greatly inhibiting consequences to the life insurance industry and the policyholders themselves.

If the American public is underinsured, as the chairman and others at this hearing have suggested, Mr. Chapoton's suggestions couldn't be more misplaced. They will not only do nothing to remedy that misunderstanding—they will in fact increase it.

If there is one thing my many years in life insurance sales have taught me, it is that the availability of life insurance loans free of taxable income generation is a key factor in the placement of life insurance. We urge you to follow your initial inclination and reject any proposals for change in the taxation of the policyholder.

AALU is most appreciative of the opportunity of presenting its views to you. We would be pleased to provide you with any further assistance as you may require. Thank you.

[The prepared statement follows:]

STATEMENT OF FRED R. KISSLING, JR., CLU, PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

My name is Fred Kissling and I am a general agent in Lexington, Kentucky, for New England Mutual Life Insurance Company. I appear before you today in my capacity as President of the Association for Advanced Life Underwriting (AALU) and I am accompanied by Gerald H. Sherman and Stuart M. Lewis of the Washington, D.C. law firm of Silverstein and Mullens.

AALU is a national organization of approximately 1,100 members specializing in one or more fields of advanced life underwriting. Collectively, our members are responsible for annual sales of life insurance in excess of $2 billion. We are, therefore, vitally interested in, and affected by, any change that may occur in the income taxation system which is applied to the life insurance industry, generally, and to the life insurance product, specifically.

As agents whose day-to-day activities are concerned with matters of marketing and sales, we are members of a company's field force and have lesser knowledge respecting its home office. We would, therefore, not presume to offer counsel on home office matters such as company taxation. However, we do have useful knowledge of the ways in which Federal income taxation of life insurance will affect its availability to the public. Our testimony will emphasize this aspect of the Subcommittee's inquiry.

We would urge that, in your consideration of this imense and far-reaching subject, you maintain in constant focus certain basic propositions that are essential to the continued good health of the life insurance industry:

(1) The availability of insured death benefits constitutes a unique economic and social advantage that should be encouraged by the Federal income tax system.

(2) A reasonable and fair Federal income tax burden should be imposed on the life insurance company incomes which serve as the source of insured death benefits.

(3) The traditional and time-honored Federal income tax treatment of the benefits that emanate from the life insurance policy in the hands of the policyholder and policy beneficiary should be continued without change.

(4) That portion of the Federal tax system which encourages utilization of insured death benefits should not be extended to investment vehicles which do not have as their primary function the provision of such benefits.

We will briefly comment on each of these propositions.

A. THE INCOME TAX SYSTEM SHOULD ENCOURAGE INSURED DEATH BENEFITS

There are many ways by which capital can be accumulated for future disposition: For example, funds can be placed in a separate account on which interest is to accumulate. They may be invested in equity instruments such as stocks. They may be converted to in-kind assets such as plant and equipment to be utilized in a business or such as a home to be utilized by individuals for shelter. Funds may be accumulated solely for retirement purposes. They may be assigned to purchase a contract which has as its primary purpose the provision of insured death benefits. They may be accumulated in other ways and for other purposes.

Where income may be assigned to any use desired by its owner and may be reached without disposal or conversion of the underlying principal, that income, under standard concepts of Federal income taxation, is subject, at reasonably frequent intervals, to taxation as ordinary income. Alternatively, where the income may be put to any use, but is not reachable without disposal or conversion of principal, the income is often subject to the reach of taxation under more favorable capital gains rates. Where the capital gain and the property from which it is spawned are specially appropriated to a social use meriting special protection, such as functioning as business plant and equipment or as a personal residence, the tax system affords additional encouragement, e.g., faster than useful life ACRS deductions and, in certain circumstances, the exclusion from income of the first $100,000 of gain on the sale of a residence. In the case of income accumulated specifically for retirement purposes, special tax treatment includes deductions for contributions to qualified plans and the exemption of income from taxation until applied directly to retirement purposes. In the case of life insurance there are, in various circumstances, exclusions from taxable income, including such an exclusion when death benefits are paid.

That the accumulation of capital and income to be paid solely for the benefit of the beneficiaries of a decedent serves a social purpose at least the equal, and likely the superior, of accumulation for housing or for use in retirement benefits is, it seems to us, self evident. While many forms of capital and income accumulation, such as are afforded through a bank account or a corporate security, can be used to provide after-death protection, so may they be used to provide housing and retirement protection. The pivotal difference, of course, is that in the case of the purchase price of a residence, the contribution to a qualified retirement plan or the payment of a life insurance premium, amounts are committed from inception to a socially protected purpose and in the normal course are not available without cost for other purposes. In one form or another, for totally valid reasons, and with advertent Congressional attention, these social purposes are reflected in a tax system that encourages them—insured death benefits no more than others.

While we are not aware of a scientific way to measure the quantum of encouragement that the income tax system should afford to insured death benefits, we have no hesitancy in suggesting that a level of encouragement commensurate with that already in place should be provided. The current process of reexamining the tax treatment of life insurance, wherever it leads, should not result in the removal of any such encouragement.

3. LIFE INSURANCE COMPANIES SHOULD BEAR A FAIR SHARE OF THE FEDERAL INCOME TAX BURDEN

AALU is not suggesting that the life insurance system in the United States deserves in any sense a "free ride." We in the industry must include within our functions the role of missionary, bringing to the attention of the American public and the Congress the importance of life insurance and of the need to provide it with a cogenial environment. In contrast, we have a directly related obligation to ensure that the industry pays its fair share of the Federal income tax burden. The place within the industry to which that tax burden should attach is life insurance company net income. In fact, the system of life insurance company taxation that is currently in place has produced billions of dollars of Federal revenues for many, many years.

Questions have now been raised respecting the equity and efficiency of that system, respecting the ways in which the net incomes of the companies should be measured, and respecting the degree to which there is currently an equitable balance of the burden between stock companies and mutual companies. as I said originally, we, as agents, are not specially equipped to provide direct guidance in seeking the answers to these questions. Although we leave that to the companies which have staffs that are far more expert in these matters than are we, AALU is extremely interested in the answers that are finally reached. The American life insurance policyholder—the person to whom we sell the policy—will ultimately bear the burden of the taxes that are imposed at the company level. In that sense we obviously are selfishly motivated to urge you to keep those taxes low. However, that selfish motivation must be subservient to the overriding obligation to urge you to keep those taxes equitable and fair, not only to life insurance companies and policyholders, but to the Federal need for a reasonable level of revenue.

C. THE CURRENT INCOME TAX TREATMENT OF THE POLICYHOLDER SHOULD NOT BE CHANGED

For as long as I can remember, and I have been in the life insurance business for thirty years, the Federal income tax laws have applied to the life insurance policy a constant and well understood system of income taxation:

Except in certain business situations, the payment of premiums does not result in deductions from income. Accumulating cash values in the policy will produce taxable income to the policyholder only as they are paid out and only in an amount equal to the excess of the amount of the payment over the premiums previously paid into the policy. At death, except in certain situations where the beneficiary has acquired the policy after its origination in a transaction involving valuable consideration, the policy proceeds are not subject to Federal income taxes.

This whole system is applied to policy benefits that are paid by life insurance companies from their net premium and investment income after expenses and after a payment of Federal income taxes at the company level. Thus, neither the policyholder nor the beneficiary in most situations pays a direct income tax with respect to the insurance policy, although the benefits received are in an after-tax form, i.e., after reduction for Federal income taxes paid at the company level. This system has shown itself to be equitable, to be encouraging of the development of life insurance benefits, to be simple enough at the policyholder level so it is satisfactorily understood by him, and to be totally consistent with the subjection of the industry to such Federal income taxes as the political system and the dictates of good Federal income tax policy require.

Irrespective of any need that may be perceived for adjustment of the details of the taxing system as applied to companies, no need exists for changing the basic conceptual system or for changing the place in that system where the policyholder has for generations found himself. We urge this Subcommittee to take no steps that would upset this delicate balance. For example, any change that would place the incidence of taxation on policyholders could easily be perceived by them as a devaluation, through the tax system, of life insurance generally. It would, thus, misleadingly serve to cause life insurance to be thought of as offering a lesser benefit. This would be true even though the increase in the burden of tax at the policyholder level is offset by a reduction of what would otherwise have been the burden at the company level. Our focus here is not on what total burden the industry should bear, but on how that burden should be distributed so that it is not misperceived by the public.

That similar misperceptions can occur is graphically illustrated by the millions of Americans who apparently have viewed interest and dividend withholding as a new tax. Whatever the merits of such withholding, and reasonable men certainly can differ, the effects of such a misperception can be easily seen. As applied to the life insurance policy, we would be fearful that even such an innocent phrase as "proxy tax" would mislead policyholders into believing that they are now subject to new and debilitating tax burdens.

D. THE SYSTEM OF TAXING LIFE INSURANCE SHOULD NOT BE APPLIED BEYOND CONTRACTS DESIGNED PRIMARILY TO PROVIDE INSURED DEATH BENEFITS

It has been suggested that, as a result of the recent inflationary and high interest rate economy, attempts have been made to wrap investment vehicles (such as mutual funds) in a thin layer of term insurance for the sole purpose of providing them with life insurance policy income tax treatment. Thus, a system which is designed to encourage death benefits through application of a specific income tax technique is used or, more accurately, misused as a means of avoiding what would otherwise be a reasonable income tax burden. All of us have read newspaper advertisements proclaiming the availability of such schemes and can but not vigorously in assent to the suggestion that this is not right and should be discouraged.

AALU holds no brief for this kind of misuse of life insurance. We would, therefore, urge that this Subcommittee devote special attention to the development of a definition of a life insurance contract such that the system of taxation applied to the life insurance industry is not available for investment vehicles masquerading as life insurance.

The current Revenue Code definition appropriate to flexible premium policies (§ 101(f)) may not have been in place long enough to serve as an absolute proving ground of at least one form of definition. However, it would appear to us to serve as a reasonable point of departure for further consideration and analysis. Please bear in mind that the attempt should not be merely to exclude the undeserving case, but more precisely to include, with a broad reach, the many and varied forms of traditional life insurance coverage.

AALU is much appreciative of the opportunity of presenting its views to the Subcommittee. We would be pleased to provide such further assistance as may be requested. Thank you.

Chairman **Stark**. Thank you, gentlemen.

I have a question for Mr. Gregg. Yesterday I think Professor Belth would have agreed with you that Americans need insurance. He argues that they probably need more than they already have, but he also suggested that the savings element has been overemphasized in a lot of products, partly because of the tax rebuildup. There is an attractiveness to that, and therefore they don't have enough total protection. How would you respond to that, Mr. Gregg?

Mr. **Gregg**. I think in two ways, Mr. Chairman. The cost of insurance has been going down historically. People, to keep up with inflation and the increased costs of living, have been asking for more insurance. But I would particularly point to the Williams study mentioned in our prepared statement, which shows that very few term policies result in death claims. It would be a hollow statistic for families to have high amounts of insurance if that insurance never pays off. Maybe that is one answer to Professor Belth's point.

Chairman **Stark**. Mr. Kissling, in your prepared testimony, particularly on page 12, you urge us to get into the question of defining life insurance contracts. I think you are suggesting that as a way to limit the attractiveness or the extent to which some of the newer products called universal life or the jumbo dividend policies, whatever you want to call them, are finding their way into the market.

Don't you feel that a limitation on the tax deferral of the inside buildup would accomplish that without regard to how we design it. But if these companies selling it have to pay a tax before you can offer your customer these larger cash value products, don't you think that would reduce their attractiveness and marketability? Or, on the other hand, do you think we should get into more of the definition, as Mr. Gregg suggested we did in TEFRA, where we spell out percentages of cash value to face value?

I guess the other approach to taxing the inside buildup is to write legal definitions. I always begin to worry once you write legal definitions because the next thing that could follow is regulation of the product.

Mr. **Kissling**. Definitions are very important. As I mentioned a while ago, life insurance contracts should be defined to exclude investment vehicles that are camouflaged as life insurance and to include with a broad reach the many and varied forms of traditional life insurance coverage. I think that pretty well states our position.

Chairman **Stark**. Thank you. Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman. You gentlemen in effect represent the agents who are out there selling policies. It was stated here that insurance policies are not bought, they are sold. Do you agree with that?

Mr. **Gregg**. Would you please repeat the last part of that sentence.

Mr. **Schulze**. Policies are not bought.

Mr. **Gregg**. That is correct.

Mr. **Schulze**. In other words, the inference is that the individual doesn't sit down and say, "Gosh, I need insurance, I am going to go out and buy it," but that it is an externally instigated motivation, that an agent comes and sits down and says, "Do you realize that you are going to die someday and you are going to leave this poor lady without any source of revenue?" From an agent's point of view, what is your opinion of that statement?

Mr. **Gregg**. I will speak for myself and Mr. Kissling, because together we have 64 years of this, and I have yet to have anybody walk into my office and volunteer to buy life insurance. It is sold. I would like to have it work the other way for a while, but it doesn't do it that way.

Mr. **Schulze**. So that the agent is an essential part of this chain, as it were?

Mr. **Gregg**. Yes.

Mr. **Schulze**. Were it not for the agent, the insurance business would not be as large or successful as it is today. Mr. Kissling, do you agree with that?

Mr. **Kissling**. Regardless of what you hear, insurance is sold by the agent. It isn't done by mail.

Mr. **Schulze**. Are the products created by the companies or are they created by demand? In other words, do your agents make recommendations to companies and say, "In order to be competitive we have to have this type of a product"? Do you have that kind of an input, or do you just sell the product that they make available to you?

Mr. **Kissling**. I think that would vary by the company. Most companies that I am familiar with have agents' associations that make recommendations on what the public is interested in.

Mr. **Schulze**. I guess what I am trying to determine, in most other industries in the country, consumer demand pretty much creates the size and shape and packaging of the product. The insurance industry may be a little unique in that it comes from the top down. They say, "Here is what is available, take it or leave it," and that is what I am trying to determine.

How much consumer input, how much does the marketplace say, "This is the product I want"? In other words, is the marketplace today saying I want a greater savings element in this product, or is this being handed to the marketplace?

Mr. **Gregg**. Mr. Schulze, our industry tries to respond, certainly, to the wants, desires and needs of the buying public. Historically, as you well know, sir, there are two kinds of life insurance policies, term and permanent insurance. Permanent insurance came about as the result of a broad demand for a level premium which can start at age zero and, theoretically if not technically, go to age 100.

The policies that you are talking about are the ramifications of the ordinary contract and in some cases combinations of term insurance and permanent insurance of one kind or another. Certainly our industry responds to the marketplace, and we as agents carry those messages from the marketplace to our home office.

Mr. SCHULZE. I have had agents tell me that business is getting so complicated that they need a computer in order to really determine the product. Would you agree with that? Do you see that business is getting too complicated?

Mr. GREGG. Yes, it is complicated, but to help us through the complications, we are blessed with our own computers. How we would have done what we do now 30 years ago I don't know, but we have our own computers and we have all of this information stored in our own computers. We operate with them and it makes it easier.

Mr. SCHULZE. One final question. What would the results be at your level if we did decide to tax cash value loans, dividends, all of those things which are now not taxed that go to the policyholder? How large a roadblock or a detriment would that be in the sales process of your product?

Mr. KISSLING. I would not answer for the sales process, but I would emphatically say it would destroy one of the basic fundamentals on which the capital formation concept has been built in America.

Mr. SCHULZE. Do you think that it would reduce sales? When you are selling a product do you have to say to the people, "Of course, if you can take a loan on this policy, you are going to be taxed"? Or "If you are going to receive dividends, they are going to be taxed"? What kind of a reaction would that cause?

Mr. KISSLING. It would shake the confidence in the product. Whether it would reduce sales or not, that would remain to be seen, but it would destroy one of the basic concepts that America has been built on, the ability to protect your family or your business.

Mr. GREGG. I think it would be devastating to our industry to have that happen.

Mr. SCHULZE. Thank you. Thank you, Mr. Chairman.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Congressman Schulze was asking you about investment characteristics of insurance policies. Isn't it true that in the late 1970's the reason the industry changed its products so dramatically is that it was finding it difficult to compete with all sorts of high-flying money market schemes and other instruments that lured people who wanted to save some money in various investment alternatives away from the life insurance industry? Isn't that what persuaded in large measure the development of some new instruments?

Mr. KISSLING. I am going to let Mr. Sherman answer that question.

Mr. **Sherman.** I am sure that the availability of high interest rates impacted negatively on the insurance product because other financial institutions also have salesmen who sold high interest rates successfully in competition with death benefit. Many segments of the life insurance industry clearly responded to that commercial burden.

I don't think there is any question about the fact that high interest rates have had an effect on this industry in many, many ways.

Mr. **Dorgan.** Given that the monetaries took over at the Federal in late 1979, that we've had a roller coaster ride on interest rates since then, and given that it has not only cost people a lot of money when they borrow money and have to pay that interest rate, but it also has provided higher yields on savings and as far as investment forms, money markets and others, it has forced the insurance industry to reexamine the kinds of policies that they offer and restructure as far as instruments that they sell.

At least I assume that is the case, in order to compete in that timeframe. Do you generally agree with that?

Mr. **Sherman.** In general, I would agree that interest rates affected the industry in that way, among other ways. If you are not returning to an investor—to one who is putting up his dollars—an amount commensurate with what he could get elsewhere, you are going to be in a negative competitive situation.

Mr. **Dorgan.** I think that is the event that stimulated the dramatic changes we have seen. Hopefully we will move now toward a more stable period of monetary policy and stability in interest rates.

Then the statement you made, Mr. Kissling, in support of Mr. Chapoton's statement and the statement that many of us made on the committee that we really need a definition of what life insurance really is, what a life insurance policy really is becomes important. There are products that are thinly veiled as life insurance products that are really investment products. I think this injures, in the long term, the opportunity to maintain the relationship we have always had, allowing an inside buildup in the life insurance investment product.

When you have abuse and go far afield, you start trying to correct the abuses and you also in many cases are persuaded to move farther down the road on what your industry has been able to offer investors. That is why I support Mr. Chapoton's statement that we really need a definition of what life insurance policies really are.

You indicate on page 11 all of us have read newspaper advertisements as to the availability of this scheme.

Can you give me any idea how flagrant you think the abuses are?

Mr. **Kissling.** It only takes a look at the financial section of this morning's Wall Street Journal and the New York Times to answer that.

Mr. **Sherman.** Mr. Congressman, if I may join in, in fact as you point out, we acknowledge in our statement that there are abuses, that there are investment vehicles that are out there saying,

> We will put two cents of term insurance on top of one hundred thousand dollars of cash accounts, and we will give you all sorts of tax-free returns, irrespective of the insured death benefit we offer.

In that sense, AALU and the Treasury see eye to eye. We think there is a need for a definition. We are concerned that if an adequate definition isn't proposed, we will get sucked under with those camouflaged investment vehicles. That will destroy the insured death benefit product which is all we are interested in protecting.

In part answer to a question that the chairman previously asked Mr. Kissling—which would be better in clearing the air, a definitional approach or some sort of minimum tax ability level approach—we are concerned that the latter taxability approach will destroy or certainly impair, not only the investment product masquerading as life insurance but the life insurance product itself. The very availability of a special corridor of taxation will provide a blueprint for every instrument seeking, fairly or unfairly, to obtain life insurance policy tax treatment. We don't want that either.

We would very much urge you to protect traditional life insurance benefits. I don't want to emphasize the word "traditional" too much because, as you know better than I, there is a bit of a dispute out there as to what "traditional" means, but certainly a product that is designed to and does provide death benefit with some rational relationship to premium charge and cash value is what we want to protect. We don't want to bring anything else into the definition.

Mr. DORGAN. What I am trying to do is underscore what you are saying. That is that some product offerings that are far afield from insurance, but are thinly veiled as insurances, are going to ultimately threaten the traditional treatment, given insurance contracts that are also investments.

I am mindful of the concern that many have expressed who have testified before this committee of the need for this country to encourage savings. We face very tough competition decades ahead with some very tough customers overseas whose savings rates are greater than ours, and we have got to encourage savings in this country.

It is clear, however, that it has to be done in a balanced way, because incentives for savings in the Tax Code in some cases are in conflict with general questions of fairness in tax treatment of various kinds of income. The traditional treatment of inside buildup in life insurance contracts has been, I think, reasonable and well accepted. But what has developed probably because of uncertainty in interest rates and so on over the past years are some significant abuses in products that are offered as life insurance. One of the first slants we ought to take here is to cut off those abuses.

That takes care of one of the major areas of problems that most of us view when we take a look at the taxation of the life insurance industry. I appreciate the comments you have in your testimony that support Mr. Chapoton on that point. It also supports the feelings of many of us on the committee on that very point.

Mr. DOUDS. Mr. Dorgan, at the same time I think we would underscore the great difficulty that we see in defining life insurance. We hear terms such as "abuse". We hear phrases such as "products thinly-veiled" and so forth, but when you try to define what they are, it is a very difficult thing to do.

I think we would all agree that we are opposed to contracts which masquerade as life insurance or which are camouflaged as life insurance, if in fact they are not life insurance, but the problem arises in defining what life insurance is. Theoretically, I suppose, an all-or-nothing test exists. If any part of the contract is life insurance, the whole thing may be life insurance.

Mr. **Dorgan**. Those definition questions are always enormously complicated. Serving on the Agriculture Committee previously, the question was always, what is a family farm? My response was it is easier for me to say what it isn't than what it is, and the same thing is probably true of life insurance.

Michael Angelo was once asked how he sculpted David, and he said, "I took a piece of marble and chipped away everything that wasn't David." Maybe we ought to go after life insurance in the same way. We can, I think, start by defining what we know isn't a life insurance contract and come up with some reasonable definition.

Mr. Chapoton, as you know, was not able when I asked him to give specifics of how you define life insurance policies. But it is clear that it ought to be one of the tasks that we undertake, and it would resolve at least one of these serious problems that I see existing that does threaten the valid traditional treatment of the life insurance policies for tax purposes.

Thank you very much.

Chairman **Stark**. Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Let me pursue that same line of questioning for a few minutes. Let's put aside traditional products and discuss the guidelines on universal life products.

Yesterday I asked Mr. Chapoton if he thought those guidelines were adequate and if we should keep them. He said no. In your testimony, Mr. Gregg and Mr. Kissling, you agree that no change should take place. Do you think we should set aside those guidelines, as Mr. Chapoton does, or do you think we should just improve them?

Mr. **Sherman**. If I may, Ms. Congresswoman, we really haven't come to a conclusion as to what that definition would be. We have suggested in our testimony that the 101(f) guideline in TEFRA is an appropriate place to start. We simply have not concluded on the point.

I might add, and not facetiously, that many of our members work with and for companies that have one view on this subject; others work with and for companies that have another view on this subject. We are just not in a position to choose between squabbling parents.

It is a very difficult problem. We appreciate the positions of both. Conceptually we are not sure where we would come out, and we would simply request your indulgence on that kind of question.

Mrs. **Kennelly**. Mr. Kissling, do you think the problem is that almost everybody wants us to keep the traditional products the same in terms of taxation, and just define the new products rather than tax them?

Mr. **Sherman**. I am sorry, I didn't quite appreciate the question, Mrs. Kennelly.

Mrs. **Kennelly**. In your testimony, and it was excellent testimony, you constantly said that insurance historically protects women and children, is an investment like a house or diamond ring, and that is the way it should be left.

What I am trying to determine is whether you think it is possible to set aside traditional products, and then just deal with the tax treatment of the new products. Would that satisfy you?

Mr. **Sherman**. I don't mean to be evasive. I am not sure what you mean by "just put aside the traditional and deal with the new."

Mrs. **Kennelly**. I guess what I mean is leave them alone.

Mr. **Sherman**. Yes, we would think it would be fine to leave alone the traditional products. However, we are not negative with respect to the new products. We simply don't know where the line should be drawn, just like Mr. Chapoton didn't know where the line should be drawn in determining the insurance income of a mutual company.

We think it will be possible, to define life insurance products so it takes into account all the old and new products that are really death benefit protection vehicles. Those old and new products which are not will simply not survive to see the next version of the law of the taxation of life insurance.

Mr. **Gregg**. I think we have to be careful, Mrs. Kennelly, in wording and accepting the question quite that way, because some of the new products are terrific.

Mrs. **Kennelly**. They are terrific, did you say?

Mr. **Gregg**. Pardon me, ma'am?

Mrs. **Kennelly**. Terrific or terrible?

Mr. **Gregg**. No, terrific.

Mrs. **Kennelly**. Terrific.

Mr. **Gregg**. Terrific products. Some of them are abusive. It is the abusive new products that you are addressing your question to. Then again the question is, if you set aside the old policies, then at what point or where is the line drawn when you decide that a new policy is either abusive or nonabusive?

Mrs. **Kennelly**. So, Mr. Gregg, we all are in the same spot trying to decide how you define life insurance policies.

Mr. **Gregg**. I think so, but we will help in any way we can, if we can be of any service to you.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman.

I think both of you heard Mr. Marriott's suggestions that mutual companies and stock companies should operate the same way and perhaps be taxed the same way. Would you care to comment, Mr. Gregg or Mr. Kissling?

Mr. **Gregg**. Mr. Duncan, I am going to opt out of that. We do believe the tax law should be neutral as between companies. There are so many good things about each, but it is not in my area of expertise, and I would like to opt out, please.

Mr. **Duncan**. Yes.

Mr. **Kissling**. I am going to have to leave to others the problem of addressing that subject.

Mr. **Duncan**. I understand. Thank you very much. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

I want to thank the panel for their testimony. I want to talk about the inside buildup just a moment, to see if you could give me some figures, if they are available, or the average cash value. Is there such a thing? Is there any way to determine that?

Mr. **Gregg**. Perhaps by estimation. In 1981, the average size cash value policy was about $9,800. The amount of cash value would depend on how long the policy was in force. As an example, after 5 years a policy issued at age 35 might have a cash value of about $55 per every $1,000 of face amount.

Mr. **Jenkins**. Most of the witnesses thus far have indicated that the vast majority of people who benefit from the tax-free buildup are those people in the middle and lower income groups. I was just curious as to what we are talking about, on an average, when we are talking about inside buildup, and how it relates to an average policyholder. The inside buildup is basically that it is analogous to an appreciation that is not yet received but will possibly be taxed if the policy is surrendered early.

Mr. **Gregg**. Except that the premiums were made with after-tax dollars in the first instance.

Mr. **Jenkins**. Let me ask you this. How do you respond to people who advocate taxation of inside buildup when they point out that withdrawals from retirement and pension plans are currently taxed, but a loan on the cash value of an insurance policy is not taxable. How do you differentiate between the two?

Mr. **Sherman**. For one thing, the situation with respect to a retirement plan is built upon a deductible input, which is not the case with the premium of a life insurance policy.

Second, as I recall the debate regarding the change in the loan rules for qualified retirement plans, the change was proposed, supported and, I assume, passed on a series of horror stories about professionals who were putting into the plans huge deductible amounts and then borrowing those amounts out of the plans free of tax.

That simply is not the case with the life insurance product. It never has been. There is no section 264 limiting the interest deduction on loans from retirement plans. There is a whole array of tax advantage arising out of a deductible input arbitraged against a nontaxable loan drawdown in retirement plans that has no applicability to life insurance.

Mr. **Jenkins**. Mr. Gregg.

Mr. **Gregg**. Amounts credited to the cash value of a life insurance contract are taxed only when withdrawn and to the extent that the withdrawals exceed the aggregate premiums paid by the policyholder for the contract. Thus, cash values are not current income. Rather they are merely a measure of accumulation that the policyholders may, in fact, never realize. They are an accumulation that in most cases will remain only beneficial interest. It is [illegible] longstanding principle of tax law that income is not taxable until it is realized either actually or constructively.

Mr. **Jenkins**. I agree with that general principle. Essentially, what you are saying is that in order to realize the buildup in current income, you have to surrender the policy. Where we get into a gray area is in the borrowing aspect of an insurance policy, but there is really no difference between that and deferring the tax on that until a certain age than there is in deferring taxation of inside buildup until a time certain, generally death or retirement, or the surrender of the policy.

Mr. **Sherman**. If I may, Mr. Jenkins, I would disagree with the statement. If I put a dollar in an IRA, and I am in the 50 percent bracket, it costs me 50 cents. If I pull the dollar down tomorrow tax free, I have just made 50 cents on Uncle Sam.

Mr. **Jenkins**. This is aftertax dollars.

Mr. **Sherman**. If I put a dollar in an insurance premium and then I draw a dollar down, I am back where I began. I think there is a major difference.

Mr. **Jenkins**. My time is up. Thank you for your testimony.

Chairman **Stark**. Mr. Moore.

Mr. Guarini.

Mr. **Guarini**. As I understand it, you gentlemen all write for mutual companies, is that correct, or do you write for stock companies also?

Mr. **Gregg**. I write for one company.

Mr. **Guarini**. But the rest of you?

Mr. **Gregg**. No, that is not quite a proper answer. I write all of my group insurance with a stock company, all of my ordinary products with a mutual company.

Mr. **Guarini**. Is there more money to be made in the creative policies and new type of policies than with the old standard policies, or is it the same? Which would you rather sell, a new form of insurance policy or sell something that has been around a long time as a standard, proven product?

Mr. **Gregg**. I have never sold one of the new policies. Personally, I have not done it.

Mr. **Guarini**. How about Mr. Kissling?

Mr. **Kissling**. I don't think I am qualified to answer the question. I try to sell what the policyholder needs.

Mr. **Guarini**. What gives you the biggest commission, what would prefer to sell if you were in business to make money?

Mr. **Kissling**. If I can answer that question truthfully, I never look at commissions.

Mr. **Guarini**. I don't know whether I accept all of your answer, but nevertheless I will take it on face value. You are a very unusual man, Mr. Kissling, in the marketplace.

Mr. Gregg, do you have an opinion?

Mr. **Gregg**. A man said to me the other day, "My company happens to be coming out with a universal life product in the very near future." To date, my company has not had one, which is not the reason I have not sold one, because I can broker with almost any company that I want to, but on the one hand you have term insurance, on the other hand you have the old ordinary life contract or whole life contract, and then along comes the variable premium, the flexible premium contract with the name of universal life. In the marketplace, there would be a need for all of those products.

There would be a need for term insurance. My own kids are young and married, and I am a grandfather, and they buy term insurance to cover those obligations. To a person my age, I would sell ordinary life. For somebody in between, I might suggest a universal life policy, but there is a role for all of them.

Mr. GUARINI. But I assume that there is a need for everything according to what you both have said, but I am just wondering from the business aspects of it, I understand that the stock companies write more exotic, creative, innovative policies today than mutuals do. Is there more money in those new kinds of policies from a commission basis?

Mr. GREGG. It is my understanding, sir, that there is not. As a matter of fact, we are kind of interested in seeing what our own commission rates will be on those products, but it is my understanding that they do not pay more money.

Mr. GUARINI. Is the commission that you get from writing a similar policy from a stock company exactly the same kind of a commission you would get from a mutual company, or is there a difference in your business operations? That should not be a hard question to answer, because you are an expert in the field, sir, and you have spent your life in the field.

Mr. GREGG. Yes, I have. I have never written an ordinary contract with a stock company. I write my group insurance with a stock company.

Mr. GUARINI. But you are an expert in the field. You understand what is going on in the field, and I ask you a very simple question.

Mr. GREGG. I would say the commissions are the same, the percentages are the same.

Mr. DOUDS. A typical agent's contract, whether it be stock or mutual—and incidentally I should reiterate that we represent here today agents of companies which are just about equally divided between stock and mutual——

Mr. GUARINI. Then you don't think there is any greater inducement from the stock companies than from the mutual companies or vice versa so that they are both identical and the same in the kinds of business transactions that you would make with your companies?

Mr. DOUDS. I was just going to say that typically an agent's contract might provide for a commission of 55 percent of the first year's premium. Now, as Congressman Marriott testified, a mutual insurance company is going to charge a higher premium typically than a stock company would, and so perhaps the agent's commission in a mutual company in the first year would be higher than it would be for a stock company in terms of dollars, but down the road in future years, the stock company might have some other offsetting compensation plan that would equalize it in the long run.

I know that one of the problems with the new products when they were first introduced was that agents didn't feel that they paid high enough commissions, and since that time, companies interested in marketing those products have tried to adjust their compensation plans accordingly to make their compensation more competitive with compensation paid on traditional products.

Mr. GUARINI. When a new product comes on the market, is there generally an incentive to sell that new product given to the salesman or to the agents?

Mr. DOUDS. Is an incentive given?

Mr. GUARINI. Yes. Are there actual incentives that a stock company would give you in order to move a new product which would be one of their new innovative, creative, exotic kinds of insurance products?

Mr. DOUDS. I am not sure that they would. As I said, I think there was a problem initially with the new products in that the companies were not——

Mr. GUARINI. I know in the long run there is. All I am simply asking, if you were selling automobiles, you would be able to answer the question very, very easily, and I know the insurance is much more complex because you are paid the commissions over a period of time, but it is a very simple question.

Are you given additional incentives when you first sell insurance which is a new, creative kind of an insurance program?

Mr. DOUDS. No.

Mr. GREGG. The answer to that question is no.

Mr. GUARINI. It was a long, hard no.

Mr. GREGG. It is a long, hard no. Actually the demands for many of these new products come from the marketplace. There is now a second-to-die policy as opposed to the old joint life first-to-die contract.

Now as to the second-to-die contract, it is a new product and most of our portfolios carry no added commissions, no added incentives for selling it. I would guess if I were to look at my contract, that they would probably cut the commissions on it, but it is there, because of the demands from the marketplace caused by new tax laws, a brand new product.

Mr. GUARINI. But you have to sell and push a product so that your salesman understands the details so that it gets across to the public as an educational process so that it is much more difficult to sell a new product than sell a product that has been an established, long accepted product, and I just merely wanted to know whether or not you got from stock companies or mutual companies——

Mr. GREGG. Incentive.

Mr. GUARINI [continuing]. More of an inducement than you would normally get if you sold an old standard line product.

Thank you, sir.

Chairman STARK. Thank you, gentlemen. We appreciate you taking the time on behalf of your fellow agents to present this excellent testimony to us today.

Our next witness will be the Stock Company Information Group, Hertzel Z. Lebed, executive vice president, CIGNA Corp., and president, Connecticut General Life Insurance Co., accompanied by Samuel H. Turner, president and chief executive officer, Life Insurance Co. of Virginia; and Raymond H. Kiefer, president, Allstate Life Insurance Co.

Gentlemen, welcome to the committee. As we said yesterday, the panels will be accorded the same courtesy that we have accorded the representatives of the mutual companies. We will not run the lights on you, but we will run them on members in the ensuing questions, and will go around a second time if members don't have enough time to inquire. We have all had a chance, I think, to read your written testimony which will appear in the record in its entirety.

You may summarize or read portions of your testimony or proceed in any manner you prefer. We will take you in the order listed on the witness sheet, which would make Mr. Lebed our first witness.

STATEMENT OF HARTZEL Z. LEBED, EXECUTIVE VICE PRESIDENT, CIGNA CORP., HARTFORD, CONN., AND PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO., ACCOMPANIED BY SAMUEL H. TURNER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, LIFE INSURANCE CO. OF VIRGINIA; AND RAYMOND H. KIEFER, PRESIDENT, ALLSTATE LIFE INSURANCE CO., ALL ON BEHALF OF THE STOCK COMPANY INFORMATION GROUP

Mr. **Lebed**. Thank you very much. Mr. Chairman and members of the subcommittee, I will be the only member of our panel making a prepared statement. I am Hartzel Lebed, executive vice president of the CIGNA Corp. and president of the Connecticut General Life Insurance Co.

Chairman **Stark**. For the audience and ourselves, those microphones that all of you are using are not very good when you are very far away from them. It is difficult with the acoustics in this room, so I would suggest to you and all your panel that if you get close to them, everyone will be able to hear your comments.

Mr. **Lebed**. I am Hartzel Lebed, executive vice president of CIGNA Corp. and president of the Connecticut General Life Insurance Co. With me, on my right, is Sam Turner, president of the Life Insurance Co. of Virginia; on my left, Ray Kiefer, president of the Allstate Life Insurance Co.

We are here on behalf of a group of 120 stock life insurance companies known as the Stock Company Information Group. Our group represents the largest stock companies, many of the smaller stock companies, and companies from every region in the country.

In asset terms, we represent about 55 percent of the assets of the stock life insurance companies. We are relatively confident that our views represent the views of the vast majority of this country's 1,900 or so stock life insurance companies.

To get down to business, we believe that the issues before the committee involve the following: One, the taxation of life insurance companies; second, the taxation of owners of life insurance companies, in particular the owners of mutual life insurance companies and, of course, third, the taxation of life insurance products and the people who buy those products.

We think we can summarize our views on these key issues in four statements, and that is what I will be trying to do here. Our first position has to do with so-called inside buildup. Our position is that the longstanding treatment of the inside buildup on cash value life insurance policies is very desirable, is well justified public policy, and should be continued.

Of course, we are not alone on that. We believe that this traditional practice is very consistent with general tax practice. Studies have shown that the great bulk of the people who benefit from these provisions are individuals or families with adjusted gross incomes under $25,000 a year. To encourage such individuals and families to protect themselves against premature death has been and remains very desirable social policy and one that, we think, the Congress should support. In addition, this practice is quite consistent with the recent tax incentives that the Congress gave to savings for retirement.

Having said all of this, I do want to stress that we, the Stock Company Information Group, support the need for legislation along the lines of the universal life guidelines in TEFRA that are designed to preclude the use of life insurance policies primarily as tax-favored investment vehicles. On the other hand, some definition of life insurance that cleans up that issue is desirable.

Our second position has to do with the 1959 act that has been talked about a lot here. Our position is that the 1959 act is a sound and equitable conceptual basis for taxing life insurance companies. That, by and large, it has worked quite well, but it does need important modifications to meet the needs of the economic and market conditions of the 1980's.

The conceptual framework of the 1959 act is straightforward and quite sound. It says take all the income—underwriting income, plus investment income—into your tax base, deduct your general business expenses, your claim payment benefits and additions to reserves. There are then several special adjustments relating to the rather unique character of life insurance. And the end result is taxable profits taxed at ordinary corporate rates, as they should be.

Now, this act and its detail have been criticized severely for being overly complicated. We are all very familiar with that. But it is complicated because it reflects the rather complex and unique business of the life insurance business. Gentlemen, I sat here yesterday and listened to testimony all day long that said get rid of the 1959 act because it is way too complicated.

But I also heard witnesses say we have got to find some way to tax the ownership interests of mūtual policies. We have got to change the reserve positions, but we have got to do something about it for the smaller companies. We have got to do something about the issue of the definition of life insurance, and on and on—many unsolved problems, most of which we agree with.

Our belief is simply that any new approach to the taxation of life insurance companies, which indeed solves these problems, is going to end up looking an awful lot like the 1959 act and be every bit as complicated.

Let's not lose sight of the fact that the 1959 act followed decades of unsatisfactory tax schemes with regard to life insurance companies. It has now evolved over some 20 years and by and large has worked quite well. The industry has thrived. There has been very good competitive balance. The public has been well served. I don't know of any chief executive in the life insurance business who isn't quite proud of our industry's record in the last 25 years.

Now there have been some problems. Some of those problems have been solved by TEFRA, and other problems need to be solved. We believe they can be solved within the existing framework.

Having said all this, we are not saying that it ain't broke, and there isn't some need for action. The fact is that conditions of the 1980's are quite different from what they used to be, and there are problems that need to be solved. In our written testimony we have submitted a detailed proposal regarding rather important elements of unfinished business that need to be dealt with. Many of these involve making permanent some of the provisions of TEFRA that are now temporary.

One very important provision is one that would enable life insurance companies to get a full deduction for any payments or credits to their customers. That would include all such payments by stock companies. It would include that part of payments to policyholders by mutual companies that don't represent returns to their owners.

We believe that this particular provision is very consistent with general tax principles, and we were very pleased to hear Mr. Chapoton endorse this same concept yesterday.

Yesterday you heard a great deal about level playing field between stock companies and mutual companies, and my last two points relate to that.

My third point has to do with the taxation of the underwriting profits of life insurance companies. It is simply this. That in order to maintain competitive balance between stocks and mutual companies, it is very important to retain the balanced provisions of the 1959 act or something like them with respect to the taxation of underwriting profits.

Let me explain what I mean by that. Under the 1959 act, the underwriting profits of mutual companies are in effect tax free. Let me say that again. Under the 1959 act, the underwriting profits of mutual companies are in effect tax free. The reason I repeat that is that yesterday you heard a great deal of reference to $9 billion of partial deferrals of taxable income of stock companies, and not one word about the many more billions of dollars of underwriting profits of mutual companies that have never been taxed at all, and, of course, never will be.

In recognition of this particular approach to the taxation of underwriting profits by mutual companies and also in recognition of the extra risks that are borne by stock companies, such as the need for higher catastrophe reserves, the 1959 act provides for certain deferrals for stock companies. The intent of those deferrals was, and the effect has been, to provide competitive balance between stock and mutual companies as well as to provide additional protection for stock company policyholders.

The proposals that say those deferrals should be eliminated while mutual company underwriting profits should continue tax free, if enacted, would produce a very unfair competitive advantage in favor of the mutual companies. We urge the retention of the balanced approach of tax-free underwriting profits for mutual companies and deferrals for stock companies.

In fact, we have submitted as part of our proposal an amendment which would make the application of those deferrals among stock companies more even competitively, because contrary to some opinion, those deferrals are quite important to smaller companies as well as larger stock companies.

The fourth and last point that I want to make has to do with the taxation of returns to the owners of mutual companies. That point is this. Competitive equity between stocks and mutual companies requires full recognition of returns to the owners of mutual insurance companies and equal treatment between stocks and mutuals regarding the nondeductibility of those returns to owners.

Everyone is aware that when stock companies pay dividends to their shareholders, they cannot deduct those payments and, in fact, their shareholders must also pay a tax on such payments.

Now, Mr. Chapoton yesterday expressed, I thought quite well, the basic reality with respect to dividend payments to mutual policyholders. In effect, they are wearing two hats, one as a customer receiving a rebate of premiums and second, as an owner receiving an ownership return. We strongly agree with Mr. Chapoton's approach, which says the "rebate to customer portion" of dividend should be deductible. The ownership return should not be deductible.

I would like to comment on two arguments that have been made against our position on this matter. One suggests that mutual companies really aren't large business corporations, but something like folksy cooperatives. The facts are that mutual companies always have been and still are the dominant business units in the life insurance business. They control 65 percent of the life insurance reserves in our business, have 65 percent of the net investment income on life insurance reserves in our business, and are a very, very major factor. I don't have any real statistics on this, but I would dare say the research would show that many mutual companies would by size qualify for the Fortune 100, if you wanted to test that.

The suggestion that the owners of corporations that control that kind of economic activity and that kind of economic wealth should not be treated as true corporate owners and should not be taxed accordingly is extremely difficult to comprehend.

The second argument made is that under the operations of a mutual company, the policyholders' equity contribution takes the form of premiums subject to tax and, therefore, there is a real difference between stocks and mutual companies.

I would point out that for all mature stock companies, certainly a company like my own, well over 90 percent of our stockholders' equity comes from retained earnings, every penny of which has been fully taxed. There really is no difference between stocks and mutual companies in that regard.

Every time Congress has revisited this issue of whether there is an ownership portion of the mutual company policyholder dividend, they have always come down with the answer that, yes, there is, and that that portion of the dividend should not be deductible.

In the 1959 act, this is treated through the taxation of the mutual companies' so-called free investment income, which is a reasonable approach to this problem. Under TEFRA 22.5 percent of mutual company dividends are disallowed for deduction purposes, and that represents about half of what the disallowance would be under the 1959 act. In our opinion, the 22.5 percent is inadequate by quite a wide margin to maintain competitive balance, equality, and an appropriate balance of revenues within the industry. We think the free investment income approach is sound.

In our written testimony we mention some other alternatives. To the extent that we have attempted to evaluate those, we believe they would produce roughly similar results to that produced by the free investment income approach. All of our evaluations say that under current economic conditions, and this would change as conditions change, the maximum amount of mutual policyholder dividends that should be deductible is 60 percent, or 40 percent would be disallowed.

Let me just summarize these four points and make a couple of concluding remarks, and then we would welcome your questions. Position one is that the longstanding treatment of the inside buildup is very good and should be preserved.

Position 2, the 1959 act is a sound and equitable conceptual framework for taxing life insurance companies. It does need modification, but it has worked well and can be brought up to date and continue to work well.

Point No. 3, there has been balanced treatment of underwriting profits between mutuals and stock companies. Mutual companies pay no tax on underwriting profits. Stock companies get certain deferrals to offset that, and a continuation of such balanced treatment is very important to the competitive balance.

Point No. 4, that competitive balance between stocks and mutuals requires full recognition of the ownership portion of the mutual company dividend to policyholders, and equal treatment with regard to the nondeductibility of payments to owners, either by stock companies or mutual companies. As I said, in our opinion, the maximum portion of the policyholder dividend that should be deductible is 60 percent.

Let me just say, in conclusion, Mr. Chairman and committee members, that the conditions in the economy and the market in the 1980's are far different from what they were in the 1950's and 1960's when the 1959 act was developed, and changes are needed to bring the taxation system for life insurance companies up to date and to work well in all regards, but in our opinion, it would be undesirable and really counterproductive to overreact to what has been going on in the last 3 or 4 years with a radical overhaul of the present tax structure.

We believe that that is almost certain to require an enormous expenditure of dollars and human energy, and equally certain to not be equally beneficial as far as the benefits that would be derived from that. We believe that the problems that need to be solved can be solved within the existing tax structure, and that within that structure we can continue to provide good results for all concerned.

We very much appreciate this opportunity to present our views and we would welcome the chance to answer your questions.

[The prepared statement follows:]

STATEMENT OF HARTZEL Z. LEBED, SAMUEL H. TURNER, AND RAYMOND H. KIEFER ON BEHALF OF THE STOCK COMPANY INFORMATION GROUP

Mr. Chairman and members of the subcommittee: My name is Hartzel Lebed. I am Executive Vice President of CIGNA Corporation and President of the Connecticut General Life Insurance Company, an investor-owned insurance company engaged in writing life insurance and annuity products. With me is Samuel H. Turner, President and Chief Executive Officer of the Life Insurance Company of Virginia, and Raymond H. Kiefer, President of Allstate Life Insurance Company. We are here today on behalf of a coalition of stock life insurance companies which, for convenience, we have come to call the Stock Company Information Group, or simply the Stock Information Group ("SIG").

The Stock Information Group consists of more than 120 investor-owned life insurance companies. It originally was formed in the autumn of 1981 to monitor tax legislative developments, and to convey to the various life insurance company trade associations and the Government the views of its membership on life insurance tax issues. Twenty-nine of the 50 largest stock life insurance companies in the United States are members of the SIG. During 1981, SIG companies in total accounted for 55 percent of the total assets of all U.S. stock life insurance companies, 46 percent of the total stock company premiums, and 45 percent of the total stock company business in force. A list of SIG member companies is appended to this statement.

Mr. Chairman, we are grateful for the opportunity to convey to you our views on the proper income tax treatment of life insurance products and life insurance companies. A review of these issues, desirable in any event, obviously was made necessary by the enactment of amendments to the tax provisions governing the treatment of life insurance companies and their policyholders, some permanent and some temporary, as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). We commend you, in pursuing your review of these issues during the so-called "stopgap" period, for your decision to re-examine them in a wider context.

Provisions for specialized treatment of life insurance products and benefits in the hands of policyholders and beneficiaries have been a feature of the income tax law virtually from its inception. The current tax treatment is prescribed principally by section 101 of the Internal Revenue Code of 1954 (the "Code"), which governs the treatment of death benefits under life insurance policies, and section 72 of the Code, which prescribes the treatment of annuities and the surrender of life insurance and annuity contracts. In contrast, the current statutory provisions governing the tax treatment of life insurance companies are of more recent origin, initially enacted by the Life Insurance Company Income Tax Act of 1959 ("1959 Act"). The 1959 Act culminated literally decades of difficulty in prescribing successfully a method of taxing life insurance companies, which, because of the specialized functions they fulfill, are operationally more complicated than most other large enterprises. Those were decades in which several formulas for taxing life insurance companies functioned unsatisfactorily and, in some years, not at all. But for nearly 25 years the 1959 Act, with one major exception, has proved to be a workable congressional solution.

The operation of sections 101 and 72, as well as of the 1959 Act, has not been without problems. With the rapid rise of inflation and the run-up in interest rates during the 1970's, it came increasingly to be recognized that in many respects the entire U.S. tax system encountered technical problems in periods of high inflation. The tax treatment of life insurance companies was not immune from the consequences of inflation. It would be fair to say that the industry as a whole became concerned about the functioning of the 1959 act during the mid-to-late 1970's, a concern reflected in a sense on the part of many in the industry that life insurance companies as a group were being overtaxed. The response of some companies to these problems itself might be regarded as problematic. Efforts to reduce the burden of company taxation included arrangements which, although clearly permissible under the then prevailing legislation, represented a second-best solution to the problem. Of course, we are speaking principally of the resort to so-called "modified coinsurance" arrangements. Occurring independently, but at about the same time, stock life insurance companies began to develop innovative versions of traditional life insurance and annuity products which provided better value to their customers. Rightly or wrongly, some of these products elicited concern on the part of the Treasury Department.

The upshot of these developments was the most significant congressional enactment in the field of life insurance taxation since 1959: the "stopgap" provisions of TEFRA. That legislation included a major, permanent revision to section 72, altering the taxation of partial surrenders of annuity contracts. This change, when combined with an additional tax imposed on premature surrenders of deferred annuities, eliminated the attractiveness of annuities as short-term investment vehicles. In a recent address before the Association for Advanced Life Underwriting, Assistant Treasury Secretary John E. Chapoton observed that these changes constituted a "satisfactory solution" to the perceived difficulties with the use of annuities and that the Treasury has "no plans to seek any further changes in the tax treatment of annuities.

Along the same lines, TEFRA contained a new provision, of a temporary nature, designed to confirm the treatment of so-called "universal life insurance" policies as life insurance for tax purposes and, at the same time, to forestall the possible use of such policies primarily as investment vehicles. Unlike the revisions to the tax treatment of annuities, the amendments to section 101 were of a temporary nature. The stopgap legislation also enacted provisions confirming the deductibility of so-called "excess interest" credited by stock life insurance companies under both annuities and life insurance contracts. These provisions were permanent for annuities but temporary for life insurance policies.

In addition, TEFRA provided temporary relief to mutual life insurance companies with respect to dividends paid to policyholders. During the stopgap period, mutual life companies are allowed to deduct 77½ percent of dividends paid. In so providing, TEFRA departed significantly from the principles of the 1959 Act and earlier legislation, which had disallowed any deduction of dividends against a mutual life company's share of (or "free") investment income. Finally, TEFRA repealed the special provision of Subchapter L, section 820, that facilitated the use of reinsurance to reduce company level taxation.

In our judgment, the problems raised by modified coinsurance and by the treatment of deferred annuities have been satisfactorily resolved. The problems raised by other life insurance policies, as well as the proper tax treatment of life insurance companies, remain to be addressed.

Mr. Chairman, we welcome debate on these important issues. It is the belief of the Stock Information Group that a thorough canvas of the issues leads persuasively to the conclusion that the current exemption for death benefits paid to beneficiaries under term or cash value life insurance policies is demonstrably sound and should be retained. Nevertheless, we subscribe to the view that appropriate permanent legislation should be fashioned to forestall the use of life insurance policies primarily as investment vehicles, unrelated to the principal objective of life insurance: protecting beneficiaries against financial loss from the premature death of the insured. We believe that temporary section 101(f) provides a sound basis for permanent legislation with respect to flexible premium policies, and we urge that section 101(f) be made permanent.

On the company side, we have considered various alternatives to the 1959 Act as a means of taxing life insurance companies. Our consideration of this issue has led us to conclude that the 1959 Act furnishes the soundest foundation for a workable, on-going system for the taxation of all life insurance companies, stock and mutual alike. We recognize that the 1959 Act is viewed by some as complicated. But we believe that this complexity simply mirrors the complicated operations of life insurance companies; and, that the history of congressional efforts to tax life insurance companies satisfactorily, culminating with the 1959 Act, strongly suggests that Congress should proceed with caution in considering radical changes to Part 1 of Subchapter L. Our conclusion, then, is that in broad outline the pattern established by the 1959 Act should be preserved. We do, however, believe that some modifications to the existing statute are essential, and we have developed a proposal that delineates these changes. We will conclude this statement with a brief description of this proposal, and a full explanation is appended to this statement and offered for inclusion in the record.

We now turn to a more detailed examination of the issues.

TREATMENT OF DEATH BENEFITS UNDER SECTION 101

Benefits under a life insurance policy payable by reason of the death of the insured are exempt from income tax under section 101(a) of the Code. This treatment of life insurance death benefits, which has prevailed since 1913, extends not only to life insurance policies providing pure insurance protection—so-called "term" insurance—but also to plans of insurance that involve the build-up of cash values. At the same time, investment earnings credited to provide for death benefits under cash value life insurance policies historically have not been taxed to policyholders when credited. As applied to a cash value policy, then, section 101(a) can and does operate to exclude such investment earnings (the so-called "inside build-up") from the individual income tax base.

This aspect of the taxation of life insurance has attracted substantial attention over the years, particularly by those who take as their point of departure that the most desirable sort of broad-based tax is a tax on personal income measured in a "comprehensive" sense. To adherents of this view, the exclusion from the tax base of interest credited to life insurance reserves is an imperfection. And, since a "comprehensive" individual income tax is roughly the point of departure used by the Treasury Department in its annual estimate of "tax expenditures," the magnitude of the exclusion of interest credited to life insurance reserves is estimated in the so-called "Tax Expenditure Budget."

Whether a broad-based tax on income—as contrasted, for example, with a tax on consumed income—is an ideal to which as a matter of policy we should aspire is a point that increasingly is regarded as debatable. But accepting for purposes of discussion the premise that such an ideal is appropriate—and accepting as a corollary that the exclusion of interest credited to life insurance reserves is a departure from that ideal—we nevertheless believe the departure to be justifiable and desirable.

Even Henry Simons, one of the original proponents of a "comprehensive" income tax, recognized that an ideally comprehensive tax base could never be achieved. He concluded that necessary imperfections well might be regarded as tolerable from a distributional standpoint, if those imperfections were distributed in a roughly equal way across income classes.[1] Indeed, one of the principal criticisms of income tax "incentives" or tax "expenditures" is that they are disproportionately beneficial to those in the upper income brackets to the disadvantage of the lower and middle classes.

When measured against this criticism, the benefit from the inside interest build-up fares well. For example, during 1978, the last year for which we have found complete data, over 54 percent of the benefit of the inside build-up accrued to individuals having adjusted gross incomes of $30,000 or under, and approximately 72 percent accrued to the benefit of individuals with AGI of $50,000 or less. The tendency to benefit the lower ranges of the income spectrum was particularly pronounced. Again using 1978 data, over 46.5 million of the nearly 68.7 million individual income tax returns filed that year (or 67.7 percent of all individual returns) showed adjusted gross incomes of under $20,000. Families filing those returns paid roughly one-fourth (26.4 percent) of the entire individual income tax. But this income class received substantially more than one-third (36.1 percent) of the benefit of the inside interest build-up.

From the standpoint of administrability, another criterion by which tax provisions frequently are evaluated, the existing treatment of the inside build-up again fares well. Indeed, from the policyholder standpoint, the current treatment of death benefits under life insurance policies could hardly be less complicated. It is equally clear that devising a regime to tax the inside build-up, even if that could be done, would create massive problems of administration. Thus, the existing treatment has, in contrast with so many other aspects of the income tax, contributed to, rather than detracted from, the simplicity of the system.

The third criterion by which taxes are often evaluated is their impact on economic activity. And, indeed, the exclusion for interest credited to life insurance reserves is most readily justified on the ground that it encourages individuals to secure protection against the risk of premature death of the family breadwinner. Whether this is regarded as an "incentive" to the purchase of life insurance, or as a "subsidy" to the purchase of insurance, we believe that provision for this risk remains a desirable social objective that congress should continue to encourage.

Indeed, we regard the retention of an incentive to the acquisition of life insurance protection as more necessary now than ever before. The tax laws contain departures from an idealy comprehensive income tax that are many in number and substantial in magnitude. Of these, it is particularly important to make note of the extent to which in recent years Congress has been generous in providing incentives to savings for retirement. The limits on Keogh plans have recently been liberalized. The past decade has seen the introduction of, and then the liberalization of access to and limits on, so-called "individual retirement accounts." As suggested in a recent study by Henry Aaron, prepared at the request of the American Council of Life Insurance, taxing interest credited to life insurance reserves in a manner consistent with a comprehensive income tax, while simultaneously providing generous incentives for retirement savings, would substantially bias the principal investment choice that most families face: it would tend to encourage most individuals to place their savings dollars in tax-favored retirement income accounts and to discourage them from purchasing life insurance protection.[2]

It is obviously desirable for Congress to fashion tax legislation that encourages individuals to make provision for one major financial eventuality, retirement. But it is undesirable for Congress then to alter the tax laws in a way that discourages the provision of protection against another major financial risk, that of premature death. But that is precisely what current taxation of the inside build-up, in a world with generous incentives for retirement savings, would do. Viewed in this context, retention of the present treatment of the inside build-up simply preserves an incentive to insure against the risk of premature death that in a rough way balances existing incentives to save for retirement, a course that we believe to be sound.

What is more, interest credited to life insurance reserves differs in this respect from, and therefore merits more favorable treatment than, interest credited to savings through financial intermediaries such as banks. Excluding from the tax base interest credited to life insurance reserves encourages individuals to channel savings into a vehicle that also protects against the risk of premature death.

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[1] See Simons, "Personal Income Taxation" 52–53 (1938).

[2] See Aaron, "Taxation of Life Insurance Companies: A Report Submitted to the American Council of Life Insurance" 21–22 (1982). This study, in revised form, has been published as "The Peculiar Problem of Taxing Life Insurance Companies" (Brookings Institution, 1983). See pp. 14–17 of the published study.

We recognize, of course, that not all interest credited to life insurance reserves ultimately is paid out as death benefits. Policyholders remain free to surrender life insurance policies in return for the cash values that have built up under those policies. When that happens, the policyholder is taxed to the extent that the amount received on surrender exceeds the premiums paid. But in the interim the policyholder has enjoyed the advantage of deferring tax on the earnings. Nevertheless, the bulk of life insurance benefits (other than policyholder dividends) paid by life insurance companies consist of death benefits. For this reason we believe that, in the context of the tax law as it now exists, the present treatment of interest credited to life insurance reserves should be preserved.

Finally, we do not regard it as entirely sound—indeed it may prove to be affirmatively unsound—to evaluate the existing treatment of earnings credited to life insurance reserves using for comparison the ideals of a comprehensive income tax. At least since publication by the Treasury in 1977 of "Blueprints for Basic Tax Reform"—which examines possible implementation of a truly broad-based income tax, on the one hand, and of a tax on consumed income (or a "consumption tax"), on the other—it has come increasingly to be recognized that in many respects our tax system more closely resembles a consumption tax than an income tax.

The Treasury was neither first nor alone in suggesting that, when measured against the criteria generally used to evaluate the soundness of broad-based taxes, a tax on consumed income might be preferable to a comprehensive income tax. The desirability of a consumption tax has received increasing attention among economists and appears to be gaining a growing number of principled adherents. Despite this, we recognize that these hearings are not the forum in which to debate the direction in which, as a braoder matter of national policy, our tax system should move. But we think the point worth mentioning, if only because the existing treatment of life insurance death benefits is consistent with the tax treatment of all forms of savings that would prevail if we did shift from an income tax to a consumption tax.

In short, Mr. Chairman, we think that the existing treatment of the inside buildup of cash value life insurance policies is in principle sound, regardless of the perspective from which it is considered, and should therefore be retained. On the other hand, we realize that, with the advent of novel variations on traditional life insurance products, there has developed an increased concern for the possibility that life insurance products may be used, not primarily to provide insurance protection, but primarily to secure tax-favored treatment for what in effect are simple financial investments. And we endorse efforts to forestall the use of life insurance policies primarily for investment purposes through legislation embodying principles like those contained in temporary section 101(f). That provision confirms that the death benefits under universal life insurance policies will be exempt under section 101, while simultaneously denying exemption to flexible premium policies that do not meet specified statutory tests, designed to prevent universal life policies from being used primarily for investment. In our view, the limitations imposed on flexible premium policies by section 101(f) have proved to be a reasonable solution to congressional concerns about use of such policies for investment rather than insurance, and we urge Congress to make section 101(f) permanent.

LIFE INSURANCE COMPANY TAXATION

The 1959 Act represented the culmination of a literally decades-long congressional quest, succinctly chronicled in the announcement of these hearings, for a satisfactory formula by which to tax life insurance companies. Although regarded by some as arcane, the 1959 Act in broad outline is not complex. It taxes life insurance companies on the sum of the principal components of their net financial income, consisting of (1) earnings from investments in excess of earnings credited to policyholder reserves, and (2) net underwriting income—roughly speaking, the excess of current premium income over current expenses and currently paid benefits—if any. In statutory terms, the sum of these items is referred to as a live insurance company's "gain (or loss) from operations."

Life insurance companies differ from other financial institutions primarily in that a substantial component of their entity-level income consists of underwriting gain or loss, in addition to results from investment activities. In recognition of this difference, life insurance companies are, under the 1959 Act, allowed to deduct dividends paid to policyholders (primarily by mutual life insurance companies) and to defer tax on certain items. But the statute, in effect, provides that a life insurance company may apply these items of deduction or deferral only against the underwriting income component of its "gain from operations." This limitation, directly or indirectly, accounts for a good deal of the complexity of the 1959 Act.

One thing is clear: during the nearly 25 years since its enactment, the 1959 Act has operated reasonably well. It has imposed on the life insurance industry corporate tax liabilities that roughly have paralleled in magnitude the growth of the industry as a whole, rising from some $550 million in 1959 to approximately $2.775 billion in 1978.[3] What is more, the share borne by the life insurance industry of the total U.S. corporate income tax rose from approximately 2½ percent in 1959 to over 4 percent in 1978. We mention these data only to indicate that, in contrast with regimes devised by Congress in the Past to tax life insurance companies, the 1959 Act has consistently imposed on the industry a tax burden that is not small, either in absolute amount or as a percentage of revenue from the corporate income tax.

Equally clearly, the operation of the 1959 Act has not been problem free. However, much of the difficulty that developed was attributable to one of two things. First, some uncertainty arose about the proper application of existing principles to newly-developed life insurance products. Second, the formula (known as the "Menge formula") used by the 1959 Act to determine the reserve deduction allowable in computing taxable (or free) investment income proved sensitive to increases in interest rates and, at some levels, began to break down. Thus, the 1982 congressional action—which fashioned permanent solutions to some problems and provided interim solutions to others, while allowing breathing space in which to reconsider the entire spectrum of inter-related issues—was clearly welcome.

Principal among the temporary (or "stopgap") provisions, due to expire at the end of this year, was a clarification of the deductibility of "excess" interest credited to policies other than annuities. Under this provision, stock life insurance companies were allowed to deduct 85 percent of excess interest credited during the stopgap period. But, in recognition of the legal arguments in support of the deductibility of all excess interest, their ability to litigate that issue was preserved.

The stopgap provisions also included a temporary revision of the limitation on the deduction for policyholder dividends; a modification of the "Menge formula"; and a clarification that life insurance companies could file consolidated income tax returns on a "bottom line" basis.

In moving from an interim to a permanent solution, we believe Congress should be guided by three basic principles:

First, in recognition of the fact that life insurance companies, like other business enterprises, incur costs in providing goods or services to their customers, a full deduction should be allowed for amounts they credit to policyholders—at least to the extent that policyholders stand in relation to the companies as customers.

Second, in recognition of the fact that life insurance companies, like other enterprises, are profit oriented, the residual (or net) entity-level income of an insurance company should bear tax at regular corporate rates.

Third, in recognition of the fact that life insurance companies are regularly engaged in underwriting risks, the special problems of measuring entity level net income over time should be recognized and taken into account.

In applying these principles, there is one aspect of the life insurance industry that admittedly creates complications. It is that the dominating members of the industry—the large mutual life insurance companies—are not organized as investor-owned enterprises. Instead, their policyholders wear two hats. In effect, each policyholder stands in an economic relationship with the enterprise not only as a customer, but also as the owner of a share of the company equity. Consequently, mutual life insurance companies present a special problem in applying the first two principles outlined above: it becomes necessary to distinguish between the amounts they distribute to policyholders as insurance consumers, which properly should be deductible in determining their entity-level income, should be deductible in determining their entity-level income, and the net income accruing to their policyholders as equity owners, which should not. The mutuals, likening themselves to consumer cooperatives, would have this Committee believe that they should be taxed as such. But we submit that, like the net income of any other publicly-owned corporate enterprise, income accruing to the entity owners of a mutual life insurance company, who happen also to be its policyholders, should bear its fair share of tax.

In dealing with these issues, we will direct our attention, first, to the proper application of the first two suggested principles to stock life insurance companies; and, thereafter, to their application to mutual life insurance companies. After dealing with those two issues, we will direct our attention to special problems of measurement and their solution, as it or ought to be carried out, in Subchapter L.

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[3] This fivefold increase in tax liability was roughly proportional to the industry's fivefold increase in assets.

The deductibility of interest credited

For the reasons we have already set out, the existing tax treatment of the inside build-up and death benefits under cash value life insurance policies is consistent with sensible tax policy and sound social objectives. To effectuate these objectives fully, it follows that, where stock life insurance companies credit earnings to their policyholders under contracts entitled to life insurance tax treatment, they should be allowed to deduct the amounts so credited. To do otherwise would undermine the objectives of section 101.

What is more, such treatment is consistent with tax principles of general applicability. These amounts constitute value transferred from enterprise to customers, and reduce profits available to shareholders. Hence, they are properly deductible as expenses of doing business in arriving at the company's net, taxable income. Stated otherwise, they are equivalent to the cost of goods sold or of services rendered by other enterprises, costs that are universally recognized as deductibles in computing taxable income.

The 1959 Act clearly recognizes this. It allows a deduction for earnings credited by a life insurance company to its policyholders (referred to in the statute as "required interest") in computing the company's gain from operations. Nevertheless, the allowability of deductions by stock life insurance companies for so-called "excess interest" credited to contracts such as universal life insurance policies, and the treatment of similar arrangements having the same effect, has been a source of some controversy. The solution adopted in TEFRA, to which we already have adverted, was to assure such companies that they could deduct at least 85 percent of excess interest credited, while preserving their freedom to secure judicial confirmation of their right to deduct the full 100 percent.

Mr. Chairman, earnings credited to policyholders by a stock like insurance company, at least when credited at a rate guaranteed in the policy, have always been fully deductible. As we would like to take a moment to explain, excess interest does nothing more than allow a stock life insurance company to adjust periodically the rate at which earnings are credited. It would therefore serve the interests both of certainty and of sensible policy, in any more durable statutory solution, to provide for full deductibility of excess interest.

In designing ordinary (or cash value) life insurance policies of a traditional nature involving interest rate guarantees, companies have always had to reckon with the fact that policies remain in force for many years. In estimating the rate at which earnings could be credited to the contract over a protracted period, prudence dictated the use of conservation interest rate assumptions. That, in turn, necessitated conservatism in fixing premium rates, as a result of which policies were more costly than they might otherwise be had the issuer possessed perfect knowledge of future financial developments.

The need for conservatism in policy design has always posed less of a problem for mutual life insurance companies than for stocks. The former almost invariably write "participating" contracts calling for high nominal premiums. Thereafter, they can make periodic adjustments to reflect prevailing financial and underwriting conditions in fixing the amount of dividends paid to the policyholder-owner. Stock life insurance companies, on the other hand, typically write nonparticipating contracts, which do not pay dividends, and they have less margin for error in fixing premiums, at least if their policies are to be competitively priced.

Among the principal innovations in nonparticipating life insurance, such as universal life, are mechanisms through which the issuer may escape the straightjacket of assumptions based on economic conditions that prevailed when a policy was written, and respond flexibly to subsequent economic developments. One such mechanism is to credit the policy with interest at a periodically adjustable rate that is in excess of (and in addition to) the underlying rate permanently guaranteed in the policy. This, technically, is "excess interest." Using another such mechanism, the issuer fixes in the policy a maximum premium that it will charge for a given amount of coverage, but it may subsequently forego collecting the maximum permissible premium while maintaining the agreed-on coverage. Contracts containing this feature are know as "indeterminate premium policies." Whatever their precise form, such mechanisms alleviate the tension, historically most acute for the stock life insurance company, between the need for conservative design and the desire to provide a product that is competitively priced. They allow the company to provide better value to its customers.

It should therefore be clear that both credits of "excess interest" and the use of indeterminate premiums simply permit adjustments to the rate at which earnings are credited. Like guaranteed interest, credits to policyholders of excess interest operate to transfer value from the company to its customers. Like guaranteed interest, credits of excess interest reduce the net income of the company. Since credits of guaranteed interest are deductible in computing gain from operations, there is no basis for treating payments or credits of excess interest (or other arrangements having the same effect) any differently.

The problem of mutual life insurance company dividends

Even after allowance of a full deduction for amounts credited as "excess interest" (or under similar arrangements), the net income of a stock life insurance company, ultimately accruing to its shareholders, is taxes.[4] In this respect excess interest credited by a stock life insurance company—or even dividends to policyholders under "participating" policies as are issued by some stock companies—differs from dividends paid by a mutual life insurance company to its policyholders. It is partly true that mutual life insurance company dividends, like excess interest, function to transfer value from the enterprise to its customers. But, from an economic standpoint, the policyholders of a mutual life insurance company are also its equity owners—its "shareholders," if you will. Thus, unlike excess interest, dividends paid by mutual life companies simultaneously operate to distribute corporate profits from the corporation to its owners.

This distinction, Mr. Chairman, is crucial. It is embedded in those provisions of the 1959 Act that prohibit mutual life insurance companies from deducting policyholder dividends from that portion of their investment income—known as "net" or "free" investment income—that is considered to accrue to the company. And we regard it as essential that any permanent solution recognize and give effect to this distinction, as the 1959 Act now does.

The large mutual life insurance companies would have you regard them—and tax them—as through they were consumer cooperatives. We find these arguments unpersuasive. The mutuals' size, and their resulting impact on the financial markets, utterly belies their image of folksy cooperatives serving the needs of small groups of patrons who have banded together for death benefit protection. The largest life insurance company in the United States, a mutual life insurance company, has more than $62 billion in asssets. Seven of the ten largest commercial life insurers in the United States, owning (and investing) nearly $215 billion in assets, are mutual life insurance companies. This is big business, and the mutuals operate as such. In competition with stock life insurance companies, they market their products through thousands of agents, bringing into the "cooperative" thousands of new "patrons" each day. Their executives are as concerned for growth and for measures of profitability as are their counterparts in investor-owned companies. The mutuals, like the stocks, must generate earnings from investment of assets at the corporate level if their products are to be viable.

Nevertheless, the mutuals in effect maintain that they constitute (massive) pools of surplus invested capital that effectively are owned by no one; and that, accordingly, they should be freed of the burden of the income tax, rather like tax-exempt private foundations.[5] The difficulty is that mutual life insurance companies do have policyholders, and that those policyholders are entitled to a share of the income that is generated by the investment and underwriting activities of the company. In part this income is credited to the policyholders as such, much as a stock life insurance company credits earnings to pay death benefits under its policies. But the balance of the economic relationship of a mutual life insurance company to its policyholders is that of a corporate enterprise to its owners. Since income accruing to the owners of a stock life insurance company is subject to tax, whether or not distributed to shareholders as dividends, it hardly seems fair to exempt mutual life insurance companies and their policyholders/owners from corporate and individual tax.

The simple fact, Mr. Chairman, is that large mutual life insurance companies dominate the industry. About 136 mutuals have issued 45 percent of the life insurance currently in force, own approximately 60 percent of industry assets, and hold nearly 65 percent of the reserves for ordinary life insurance policies. Some 1,900 stock companies account for the balance. A tax law that conferred the opportunity for mutuals to "zero-out" their taxable income by distributing corporate-level earnings would, in such an environment, create an intolerable competitive imbalance.

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[4] Actually, it is taxed twice. Corporate tax is imposed at the entity level and individual tax is imposed on earnings distributed as dividends to shareholders.

[5] In view of this contention, one wonders how one large mutual company squares the proposition that mutual policyholders are not the company's owners with their widely televised invitation to the public to "get a piece of the Rock."

Despite this, the mutual life insurance companies now maintain, as apparently they always have, that they should be allowed an unlimited deduction for dividends paid. Evidently, they first embarked on their quest for the holy grail of an unlimited dividends-paid deduction contemporaneously with the imposition of the first modern corporate tax under the Tariff Act of 1909. Though unsuccessful that year, they returned in 1913, eliciting a response from Mr. Cordell Hull, then Chairman of this Committee, that is timely now:

"Mr. HULL. * * * [T]he mutual insurance companies desire to have themselves entirely exempted as to their net earnings from the 1 per cent normal tax imposed upon corporations. Now, when this corporation-tax law was enacted four years ago * * * it was expressly provided in that law that insurance companies, mutual or otherwise, should not be permitted, in computing their net income, to make deductions for dividends paid to policyholders. The word "dividends" was expressly and definitely inserted there upon the broad ground of public policy and of justice; that when insurance companies pay dividends out of the accumulations of the character that these companies have, they should pay the tax of 1 per cent imposed on all corporations; but they come in and say that that should be stricken out; that whenever they declare a dividend to the policyholder it is simply a return of the premium savings and constitutes in no sense net earnings in the way of interest savings or in the way of excess of the mortuary fund or from the other sources from which actual accumulations or profits arise. * * *

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"My judgment is that the accumulations of these companies which arise from savings in expenses, savings in mortality, savings from lapses and surrenders, and profits from excess interest earnings, when considered in the aggregate, are clearly of such a character as to merit the payment of the proposed tax. * * * If the companies would keep the question of premium assessments and overcharges strictly within a category to themselves and not mix and confuse them with the profits derived from the sources I have enumerated, I think it would then be possible for the law to deal with the one without affecting the other. * * *" [Congressional Record, vol. 50, at pp. 512-514 (1913).]

Years later, on the eve of the 1959 legislation, the mutuals nearly persuaded the Treasury to subscribe to their point of view. A 1958 Treasury Department draft proposal for taxing life insurance companies would have granted an unlimited dividend deduction. But the Treasury recanted, and Congress rejected the mutuals' approach in the 1959 Act.

In fashioning the 1959 Act, which for the first time since 1921 taxed underwriting income, Congress limited the deductibility of policyholder divdends. The limit was crafted by identifying that component of a company's "gain from operations" that consisted of net investment profit in excess of amounts credited to policy reserves—in other words, the company's "free" investment income. Congress then provided that policyholder dividends could be deducted in computing gain from operations, but only against that portion of the gain from operations that exceeded free investment income (plus an additional "statutory amount" equal to $250,000). Thus, putting aside the $250,000 statutory amount, the 1959 Act treated the free investment income of a mutual life insurance company as the equivalent of corporae net income, and prohibited it from being eliminated through policyholder dividends. In the words of the Senate Finance Committee report:

"In the case of participating policies (insurance written on a mutual basis) deductions are allowed for dividend payments or rate credits to policyholders . . . Under your committee's bill these dividends . . . are allowed as offsets against the phase I tax base [*i.e.*, the taxable or free investment income], or are allowed to create an underwriting loss for tax purposes, up to the extent of $250,000. Your committee realized that *to permit these* dividends to offset in *full* the phase I tax base *would in effect allow mutual companies to distribute their investment income as dividends without payment of tax.*" [S. Rep. No. 291, 86th Congress, 1st session 22 (1959) (emphasis added).]

We maintain that, when Congress acknowledged the ownership profit inherent in mutual life company investment income and limited the deductibility of dividends paid, the course it adopted was sound. That same policy was reflected in the differential limits on deductibility of excess interest, on the one hand, and policyholder dividends, on the other hand, in effect under stopgap.[6] It is a policy that should be carried forward into any long-term solution.

We believe the soundest practical approach is the "free investment income" method now incorporated into the 1959 Act. Nevertheless, at least in theory, there are other ways in which a limit on policyholder dividends could be fashioned. Recognizing that the object of any such limitation is to tax the return on ownership equity of mututal life company consistently with the taxation of earnings distributed to shareholders of investor-owned enterprises, at least two alternatives could be considered. One would be to estimate an "owners" return on mutual life insurance company surplus based on the average magnitude of shareholders dividends paid by stock life companies in relation to their surplus. Another would be to "impute" such a return to mutual company surplus derived from yields on high grade municipal securities.[7] In either case, the objective is to estimate that portion of policyholder dividends that should be disallowed so that the resulting corporate-level tax liability approximates the tax that would be imposed had the entity been investor-owned and the returns on its equity taxed as such. In each case, the computation must take into account the fact that disallowance of a corporate-level deduction results only in corporate-level tax, whereas corporate earnings distributed as dividends to shareholders are subject to both corporate and individual tax.

We will not belabor our testimony on this point. Suffice it to say that very rough estimates suggest that the "average stock dividend" approach, if applied to dividends paid by mutual life insurance companies during 1981, would have disallowed 45 percent. The "imputed return" method, if applied during the same year, would have disallowed 39 percent. Interestingly, a rough estimate of the operation of the 1959 Act provision, without regard for the stopgap provisions of TEFRA, is that it would have yielded a result that fell between the results of these two theoretical approaches: it would have disallowed 43 percent of dividends paid.

Mr. Chairman, we will be happy to refine these data and furnish them for the hearing record. They do suggest that, in electing to disallow only 22½ percent of dividends paid during the stopgap period, Congress was unduly generous. In any event, the most important point is simply that mutual life insurance companies are rather far removed from the simple cooperatives to which they liken themselves. They are among the largest corporate enterprises in the world and, properly, they should be taxed as such.

To do otherwise would be wrong in principle. It would also work to the severe disadvantage of the stock life insurance companies, who must compete with the mutuals. As a 1958 subcommittee report of the Ways and Means Committee recognized:

"* * * if underwriting income is made a significant factor in the tax base developed for life insurance companies, a serious competitive problem might arise between stock and mutual life insurance companies. Under the total income approach, all amounts returned to policyholders as dividends are deductible in computing the taxable income of the company. While in the case of so-called underwriting income this can be viewed as merely the return to the policyholders of excessive premium charges, it is argued that this is not the case where investment income is returned to policyholders. The contention is made that investment is income generated at the level of the life insurance company from its investments, and that to the extent that this investment income is taxed to stock companies at the corporate level but not to mutual companies, there is discrimination against the former. thus, it is argued that the competitive problem in the case of stock and mutual life insurance companies would require that both types of companies should be taxed upon their investment income not required for their reserves." [Report on the Taxation of Life Insurance Companies, Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, U.S. House of Representatives, 85th Congress, 2d session 7 (1958).]

In deciding not to create a tax-induced competitive disadvantage, Congress acted appropriately in the 1959 Act.

There has been some suggestion that the only tax mutual life companies should pay is a "proxy tax" on behalf of their policyholders. Such a tax, while collected from the enterprise, would be in lieu of taxing individual policyholders in relation to the inside build-up of their policies. This suggestion is unsound, for at least two fundamental reasons:

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[6] As the Senate Finance Committee report put it (S. Rep. No. 494, 97th Congress, 2d session 339 (1982)):

"With respect to the percentage limitations of 77-½ percent for mutual companies and 85 percent for stock companies, the 7-½ percent differential is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company) and accordingly, should not be deductible."

[7] Such a method was advocated by Henry Aaron, in the report to which we have referred, although we believe that his specific methodology in applying it could be refined.

For the reasons set out at the beginning of our testimony, we believe that taxing the inside build-up, directly or by proxy, in principle is wrong.

To forebear from taxing returns to equity in some of the world's largest financial institutions would be at least equally wrong.

The treatment of policy holder dividends clearly is the overriding point of difference between mutual and stock companies that the tax law must address. But there are other important differences. For example, the 1959 Act also took account of the different ways in which mutual and stock companies have traditionally aggregated funds to provide against potential adverse mortality or earnings experience—mutual companies by collecting higher, or "redundant," premiums; stock companies by placing their owners' earnings and capital at risk. The Act recognized this difference by permitting a specified deferral for nonparticipating policies, the kind of policies typically issued by stock companies, although it subjected the deferral to the same limitation that was imposed upon the deductibility of policyholder dividends.

The Ways and Means Committee report on the 1959 Act explained that this deferral was intended to compensate for the fact that "[t]o have funds equivalent to a mutual company's redundant premiums, [a] stock company must maintain relatively larger capital and surplus accounts," and in the stock company's case "the surplus generally must be provided out of taxable income." H.R. Rep. No. 34, 86th Cong., 1st Sess. 12–13 (1959). This deferral (like certain other deferrals that we will mention shortly) remains as necessary to stock life insurance companies today as it was in 1959. We therefore support the retention of ths important aspect of the 1959 Act, as well as its extension to all stock companies without regard to the 1959 Act's limitation.

Special considerations relating to the nature and operation of life insurance companies

We now turn to an elaboration of the third principle we commended to the Committee's consideration,, that is, the need to recognize and address a number of special problems connected with the annual measurement of the entity-level income of life insurance companies.

First of all, with respect to all life insurance (whether mutual or stock, and whether large or small), it is significant that claims and benefits under life insurance policies and annuity contracts may be payable many years after the inception of such contracts. Further, over the period from issuance until benefits are paid out, the life insurance company will typically receive premium payments annually (or more frequently). A portion of these premiums must be accumulated in reserves, and the company will also earn investment income each year, a portion of which (as we have previously discussed at length) the company must set aside and include in these reserves.

In order to deal with this long-term type of business and provide a means of matching income and deduction items on an annual basis, since 1909 the revenue laws (including the 1959 Act) have permitted life insurance companies to deduct the annual additions to their reserves for policy benefits. In addition, the 1959 Act permitted companies to defer taxation on a portion of their net underwriting income (if any), defined as the excess of the "gain from operations" over the "taxable investment income." This deferral arose from Congress' concern that the total "gain from operations" figure might overstate a company's true economic profit because of the difficulty of annually measuring this figure for a business that consists principally of long-term obligations. Congress therefore decided to defer tax on a portion of the gain from operations until such time as these "profits" were paid out to shareholders. The Senate Finance Committee report on the 1959 Act observed that this "50 percent reduction in underwriting gains is made because it is difficult to establish with certainty the actual annual income of a life insurance company. It has been pointed out that because of the long-time nature of life insurance contracts, amounts which may appear as income in the current year, and proper additions to surplus, may as a result of subsequent events be needed to fulfill life insurance contracts." [S. Rep. No. 291, supra, at p. 20.]

Further, because it was thought "desirable to compensate life insurance companies for the fact that in group insurance there is less than the usual diversification of risk" (H.R. Rep. No. 34, supra, at p. 13), the 1959 Act provided an additional deferral for group insurance business. The amount of the deferral was patterned after the special reserve requirements of two states for this type of insurance, and it was made subject to the same limitations as applied to deductible policyholder dividends. In 1962 the deferral was expanded to include individual accident and health insurance contracts, "in recognition of the competitive situation existing for certain companies not in a position to write group contracts." H.R. Rep. No. 2413, 87th Cong., 2d Sess. (1962).

Are these deferrals still valid today? We submit that they are, and, as our proposal suggests, we also think that the deferral for accident and health and group insurance contracts (as well as the deferral for nonparticipating contracts, discussed earlier) should be made available to all stock life insurance companies. Presently this is not the case due to the 1959 Act's limitation.

These deferrals provide needed protection for stock life insurers against the risk of catastrophies in individual life insurance, the high (and extremely volatile) risk of loss in group insurance and in individual health insurance, and any other risk not specially reserved for. Most notable in recent times is the large loss experience of health insurers. Without adequate provision for health losses, insurers may not have been able to provide the promised benefits. Another recent example of the need for the deferrals is the risk of market value fluctuations on long-term debt instruments, i.e., bonds and mortgages; value shrinkage of 30–50 percent in long-term bond portfolios was common only a year or two ago. In recent times there has been a serious invasion of company assets through policy loans and surrenders, coupled with a lessening growth rate in life companies' income, creating a strained cash-flow situation. The funds retained through these deferrals can act as a contingency reserve against the losses occasioned by run-away surrender and loan activity. It is in the interest of economic recovery, and supportive of Government policy, to encourage long-term investments, and the availability of a contingency reserve through these deferrals helps to do this.

Accordingly, we commend to this Committee the wisdom of the enactment in 1959 with respect to these deferrals, and we support their continuation (and application to all stock companies without limitation).

In the case of small life insurance companies, whether stock or mutual, special attention must be given to the income measurement problem over and above the points just discussed. The existence of these companies has been a boon to the life insurance business—frequently they are innovators, and always they add the spark of competition. Nonetheless, small companies, because of their size, necessarily bear additional risks and encounter additional problems in writing life insurance policies. In their case, it is even more true that amounts which may tentatively appear to be taxable profits will eventually diminish or turn into losses.

Accordingly, greater care must be exercised in identifying the emergence of actual (rather than supposed) profits for purposes of imposing the income tax. To this end, the 1959 Act incorporated a number of special provisions, including:

The allowance of a "small business deduction" in computing both the "gain from operations" and the "taxable investment income," equal to the greater of 10 percent of investment yield or $25,000, and

An expansion of the limitation on the deduction for policyholder dividends, nonparticipating contracts, and accident and health and group insurance contracts—the "statutory amount" of $250,000 to which we have previously referred.

We think it wholly desirable that these provisions be continued and, in fact, liberalized. The reasons underlying their enactment in 1959 remain valid today. As our proposal indicates, we would encourage the expansion of the small business deduction to a flat $100,000 amount, subject to an appropriate phase-out so that it benefits only small companies (under present law, it is available regardless of company size). Further, as was done in TEFRA on a temporary basis, the "statutory amount" in the limitation on deductible dividends and deferrals should be increased to $1 million, again subject to restrictions that limit its benefit to small companies.

Unless provisions like these are carried forward, we doubt that the existing small companies, mutual as well as stock, will be able to grow and to compete in the insurance marketplace as effectively as they have to date. Moreover, we have some doubt whether new companies will be organized. We therefore have come to believe that these provisions of the tax law, by aiding existing companies and encouraging the formation of new ones, ultimately serve the best interests of life insurance consumers.

Stock Company Information Group Proposal

The permanent changes made by the 1982 legislation solved many of the problems of applying the 1959 Act to a changing economic climate and product mix. As indicated above, however, there is still some "unfinished business." The Stock Company Information Group proposal would largely retain the 1959 Act, as permanently amended, and yet would further amend the Act in several respects to conclude this unfinished business. The proposal would ensure that all life insurance companies, whether mutual or investor-owned, remain taxed in a manner consistent with sound tax principles. In particular, by retaining the basic structure of the 1959 Act, the proposal continues the prior, well-considered congressional decisions that properly take into account the long-term nature of a life insurance company's liabilities and the differences in the underlying nature of mutual and stock entities.

To accomplish this, our proposal would amend the 1959 Act to permit an unlimited deduction for all amounts paid or credited by a stock life insurance company to its policyholders, including dividends and excess interest. In addition, the proposal would permit stock life insurance companies an election to remove the deferral for nonparticipating contracts and the deferral for accident and health and group insurance contracts from the 1959 Act's limitation. This would allow the electing companies to recieve these deferrals in full, consistent with the policy underlying the grant of these deferrals in the 1959 Act.

For small companies, both stock and mutual, the SIG proposal would revise the existing small company deduction (as defined in section 804(a)(3) of the Code) by increasing the maximum deductible amount to $100,000, with an appropriate phaseout to ensure that it benefits only small companies. Moreover, as in TEFRA, the proposal would increase the "statutory amount" under the 1959 Act's dividend limitation from $250,000 to $1,000,000, to be allocated among affiliated life companies and phase out so that it benefits only small companies.

The SIG proposal would also limit the deductibility of a mutual life insurance company's payments or credits to its policyholders/owners as provided under the 1959 Act. In this regard, it would be appropriate to examine whether, for these purposes, a stock life insurance company that is more than 50 percent owned by one or more mutual life companies should be treated as a mutual life company.[8] The proposal would, however, make a liberalizing change by adopting the "geometric" Menge formula that was included in the temporary TEFRA provisions.

In addition, the proposal would make permanent the temporary provisions of TEFRA relating to bottom-line tax consolidation, a limitation on the exclusion for group pension contracts, and a prohibition on changing a life company's qualification to be taxed under Part I of Subchapter L due to the treatment of reserves for pension contracts without permanent annuity purchase rate guarantees.

Finally, with respect to policyholder taxation, the provisions of section 101(f) would be made permanent.

A detailed explanation of the specific provisions of the SIG proposal is appended to this statement.

CONCLUSION

Once again, Mr. Chairman, we would like to thank you for the opportunity to appear here today. We offer you and the members of your Subcommittee our full cooperation in pursuing the difficult undertaking on which you have embarked. We have attempted, in the course of this statement, to respond to the questions listed in your announcement of these hearings which we believed we were capable of addressing. If further questions arise, we will be plased to provided you with our response.

STOCK COMPANY INFORMATION GROUP LIFE INSURANCE COMPANY INCOME TAX PROPOSAL

The Life Insurance Company Income Tax Act of 1959 ("the 1959 Act"), which is based on sound tax principles, generally has worked well for over 20 years. It has fairly distributed the tax burden between mutual and stock companies. Moreover, it has raised adequate, and ever increasing, levels of revenue. From 1959 through 1978, life companies' tax payments rose from $500 million to nearly $3 billion, and their share of the total corporate tax increased from about 2.5 percent to over 4 percent. In the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress amended the 1959 Act with new permanent rules to solve the problem of modified coinsurance, whereby many large mutual life companies had lowered or eliminated their taxes. TEFRA also introduced a number of temporary changes, expiring this year.

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[8] In general, taxation of the mutual life company's subsidiary in the same manner as the parent would seem consistent with the basic tenet of Federal income taxation that the substance of an arrangement should control over its form. This is because the subsidiary of the mutual life parent in most instances can be expected to operate in all respects as a mutual life company. In this respect, such treatment would appear to be necessary in order to assure that a mutual life company could not avoid paying Federal income tax merely by operating through a stock life subsidiary. Clearly, this is a problem area deserving of close study.

The Stock Company Information Group proposes to retain the 1959 Act (Part I of Subchapter L, Chapter 1 of the Internal Revenue Code of 1954, as amended), making use of appropriate temporary revisions introduced by TEFRA and making certain other changes to take into account inflation as well as new products which have entered the market since 1959. This would ensure that all life insurance companies, whether mutual or stockholder-owned, remain taxed on a fair basis, in a manner consistent with sound general tax principles. In particular, it would appropriately take into account the differences in the underlying nature of mutual and stock life insurance enterprises.

More specifically, the Stock Company proposal would amend the 1959 Act to permit a full deduction for all amounts paid or credited by a stock life insurance company to its policyholders, including dividends and excess interest, while limiting the deductibility of a mutual life insurance company's payments or credits to its policyholders/owners as under present section 809(f).[1] Moreover, except in appropriate circumstances, a stock life insurance company that is more than 50 percent owned by one or more mutual life companies would be treated as a mutual life company for purposes of these limitations.

Further, the Stock Company proposal would permit stock life insurance companies an election to remove the section 809(d)(5) deduction for nonparticipating contracts and the section 809(d)(6) deduction for accident and health and group insurance contracts from the section 809(f) limitation, allowing the electing companies to receive these deductions in full. The proposal would also revise the small company deduction (as defined in section 804(a)(3)) by increasing the maximum deductible amount to $100,000, with an appropriate phase-out to ensure that it benefits only small companies.

The Stock Company proposal also would make permanent the provisions of TEFRA relating to:

(1) The increase in the "statutory amount" in the section 809(f) limitation from $250,000 to $1,000,000, to be allocated among affiliated life companies and phased out so that it benefits only small companies.

(2) Bottom-line tax consolidation.

(3) The "geometric" Menge formula.

(4) The limitation on the exclusion for group pension contracts.

(5) The prohibition on any change in life company qualification due to the treatment of reserves for pension contracts without permanent annuity purchase rate guarantees.

(6) The section 101(f) "guidelines" for universal and adjustable life insurance policies.

Any temporary TEFRA provision not mentioned above would be allowed to expire at the end of 1983.

Current estimates show that total tax revenue from the life insurance industry in 1984 under the Stock Company proposal would be over $2.6 billion.

The following explains in detail the Stock Company proposal.

LIMITATIONS ON CERTAIN DEDUCTIONS

Prior law

Pre-TEFRA.—Under the 1959 Act (as previously amended), a life insurance company was permitted deductions for policyholder dividends, for nonparticipating contracts, and for accident and health and group insurance contracts in computing its gain or loss from operations. These combined deductions, however, were subject to a special formula limitation. Specifically, under section 809(f), these deductions could not exceed $250,000 plus the amount by which the gain from operations (computed without regard to these deductions) exceeded taxable investment income.

The principal purpose of this formula limitation was to ensure that mutual life insurance companies would pay a tax on the company's share of investment income (the "free investment income") whether or not such amount was distributed to policyholders.

Although not contemplated at the time of the 1959 Act, stock life insurance companies became subject to the policyholder dividend limitation on their traditional nonparticipating or "nonpar" contracts (i.e., contracts that do not accord policyholders the right to participate in "divisible surplus" by the receipt of dividends) as a result of positions taken by the Internal Revenue Service in 1982. Prior to TEFRA, many stock companies sought to provide contract values to their policyholders that reflected the high investment yields of recent years. In certain life insurance policies, these companies charged premiums that were lower than the maximum premium fixed in the policies ("indeterminate premiums"), and in other policies they credited interest at a rate in excess of the rate that the policies permanently guaranteed ("excess interest"). In computing their taxable income, these companies included only the payments that they actually received under their indeterminate premium policies, not the extra amounts (known as the "phantom premiums") that they might have collected had they charged the maximum premium permitted. Also, the companies fully deducted, as additions to reserves to provide for guaranteed benefits, the amounts that they credited as excess interest.

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[1] All section references are to the Internal Revenue Code of 1954, as amended.

In June, 1982, however, the Service held that excess interest credited under a universal life policy is to be viewed as a constructive dividend, effectively not deductible under pre-TEFRA law due to the divided limitation. In addition, in the same rulings, the Service strongly suggested that "phantom premiums" are to be included in the companies' income and must be considered to have been (constructively) paid out as "policyholder dividends" which the companies effectively could not deduct under pre-TEFRA law.

TEFRA.—TEFRA provided that, for a two-year period (1982 and 1983), there are alternative ways of calculating the section 809(f) limitation for the policyholder dividend deduction and other special deductions.

In general, the first method revised the prior limitation by increasing the so-called "statutory amount" from $250,000 to $1 million. This limitation applies unless, for any taxable year, the taxpayer elects to apply the alternative limitation.

The alternative generally provides a limitation determined as the sum of:

(*a*) 100 percent of the dividends attributable to insured qualified pension plans;

(*b*) a statutory amount of $1,000,000 (the same as in the first method); and

(*c*) in the case of a mutual life insurance company, 77½ percent, and in the case of a stock life insurance company, 85 percent, of the sum of the policyholder dividends (other than dividends on qualified pension business) and the deduction for nonparticipating contracts.

TEFRA also revised the manner in which the statutory amount applies to an affiliated group of life insurance companies. In the case of an affiliated group, the statutory amount is to be divided equally among the companies which are component members of the group on December 31 of each taxable year unless Treasury regulations permit an unequal allocation. The benefits from the statutory amount are also targeted toward smaller companies: the amount is phased down when the sum of the deductions for policyholder dividends, nonparticipating contracts and accident and health and group insurance contracts exceeds $4 million, and it is totally eliminated when such sum equals or exceeds $8 million. At this "large company" level, neither limitation reflects the statutory amount.

With respect to the percentages contained in the alternative limitation—77½ percent for mutual companies and 85 percent for stock companies—the 7½ percent differential reflected an effort to take account of the fact that a portion of the dividend distribution to a mutual life company's policyholders constitutes a return of corporate earnings to them (derived from their ownership interest in the company) and, accordingly, should not be deductible.

Each limitation applies first to policyholder dividends, then to the deduction for nonparticipating contracts, and finally to the deduction for accident and health and group life contracts.

In addition, TEFRA provided special grandfather relief for excess interest and indeterminate premium contracts. Under TEFRA, for taxable years beginning before January 1, 1982, if a company on its return for that year treated amounts described as "excess interest" as not being a policyholder dividend, then such amounts are so treated for tax purposes. Also, for taxable years beginning before 1982, amounts that could have been charged as a premium or mortality charge, but were not, are not to be included in premium income. The issue of whether such amounts are properly treated as policyholder dividends was left open for taxable years after January 1, 1982. No inference is to be drawn, however, as to the treatment of these items for taxable years beginning after 1981 as a result of the TEFRA provision.

Explanation of stock company position

The Stock Company proposal would provide that all amounts paid credited by stock life insurance companies to their policyholders would be fully excludable or deductable. Allowing a full deduction for amounts paid or credited to customers by stock life companies is entirely consistent with general corporate tax principles:

such amounts reduce profits available to shareholders and, hence, should be deductible as expenses of doing business before arriving at net, taxable income.

On the other hand, amounts paid or credited by mutual life insurance companies to their policyholders—who are owners of the company as well as customers—would continue to be deductible only to a limited extent. Thus, such dividends would be subject to a revised section 809(f) limitation[2] (to be described below). Such "dividends" would be defined to include any interest accrued on an insurance contract in excess of the amount of interest assumed in calculating reserves (as defined under section 810(c)(1)) and any differential between the actual premiums received or mortality charges deducted and the maximum premium or mortality charge allowable under the terms of the contract.

For all companies, the 1959 Act would be revised so as to increase the "statutory amount" under section 809(f) from $250,000 to $1,000,000 (as in TEFRA). Moreover, the proposal would require that this amount be allocated among affiliated companies, and phased out to assure that it benefits only smaller companies. In addition, the proposal would correct a technical problem which has arisen in the interpretation of the interrelationship between the allocation and phase-out provisions as originally provided for in TEFRA. The proposal would carry out Congress' original intent in TEFRA by clarifying that the increased statutory amount is first allocated equally among component members of an affiliated group and is then subsequently phased out at the individual company level.

Technically, the Stock Company proposal would amend the 1959 Act to revise the general section 809(f) limitation and to provide an elective alternative limitation. The general section 809(f) limitation—

> In the case of a stock life insurance company, on the amount of the deduction for nonpar contracts (section 809(d)(5)) and for accident and health and group insurance contracts (section 809(d)(6)), and
>
> In the case of a mutual life insurance company, on the amount of the deduction for policyholder dividends (section 809(d)(3)), for nopar contracts (section 809(d)(5)), and for accident and health and group insurance contracts (section 809(d)(6)),

Would be equal to $1 million plus the amount by which the gain from operations (computed without regard to such deductions) exceeds the taxable investment income for the taxable year.

The elective alternative would allow a stock life insurance company to remove from the 809(f) limitation the amount of the section 809(d)(5) deduction for nonpar contracts and the section 809(d)(6) deduction for accident and health and group insurance contracts. However, the electing company would not be entitled to the $1 million "statutory amount." Allowing electing stock companies to receive these deductions in full in consistent with the policy underlying such deductions in the 1959 Act. As noted in the Senate Finance Committee report in 1959, the deduction for nonpar contracts was designed "to compensate stock life insurance companies for the fact that they do not have the 'cushion' of redundant premiums (which, if the business does not go well, a mutual company can use to offset losses but otherwise are subsequently paid back as policyholder dividends)." S. Rep. No. 291, 86th Cong., 1st Sess. 11 (1959). The deduction for group life and accident and health contracts, the report went on to explain, was "desirable to compensate life insurance companies for the fact that in group insurance there is less than the usual diversification of risk." *Id.*, at p. 23. Furthermore, in 1962 Congress extended this deduction to individual accident and health contracts "in recognition of the competitive situation existing for certain companies not in a position to write group contracts." H.R. Rep. No. 2413, 87th Cong., 2d Sess. (1962).

As in TEFRA, for mutual life companies, the limitation would apply first to policyholder dividends, then to the deduction for nonpar contracts, and finally to the deduction for accident and health and group insurance contracts. In the case of stock companies, the limitation would apply first to the deduction for nonpar contracts and then to the deduction for accident and health and group insurance contracts.

Furthermore, with respect to "excess interest" paid or credited under life insurance policies issued by stock life companies, the defintion of "qualified contract" in section 805(f) of the Code would be modified to include (in addition to annuity contracts) life insurance and endowment contracts. Thus, amounts of "qualified guaranteed interest" (as defined in section 805(f)(1) of the Code) paid or credited with respect to certain life insurance and endowment contracts would be taken into account as "interest paid" (and hence fully excludable). Such contracts would include only those contracts which involve life contingencies, which are issued by stock life insurance companies, and which provide for the crediting of excess interest. Additionally, in the case of life insurance policies issued by stock life companies, premium income would include only those amounts the companies actually received, not any extra amounts ("phantom" premiums and mortality charges) that they might have collected had they assessed the maximum charge.

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[2] The proposal would not adopt the arbitrary minimum policyholder dividend deduction level of TEFRA (77½ percent) because such deduction level does not sufficiently reflect the status of a policyholder of a mutual company as an owner (i.e., amounts equivalent to nondeductible corporate dividends should not be deductible as policyholder dividends).

Under the proposal, for purposes of the section 809(f) limitation and the definition of "dividends" and "qualified contracts", a stock life insurance company that is more than 50 percent owned by one or more mutual life insurance companies would be taxed as the latter. The tax treatment of the subsidiary in these circumstances is a matter requiring attention and study. In general, taxation of the mutual life company's subsidiary in the same manner as the parent would be consistent with the basic tenet of Federal income taxation that the substance of an arrangement should control over its form. Since the subsidiary of a mutual life company can in most instances be expected to operate in all respects as a mutual life company, it would seem appropriate to tax the subsidiary in the same manner as the mutual life parent. Furthermore, such treatment would appear to be necessary in order to assure that a mutual life parent cannot avoid income tax merely by operating through a stock life subsidiary, thereby preventing a potential erosion of the Federal tax base.

SMALL BUSINESS DEDUCTION

Prior law

Pre-TEFRA.—Under the 1959 Act, life insurance companies are allowed a special deduction in the computation of their tax base of 10 percent of the investment yield (gross investment income less investment expenses) up to a maximum of $25,000. However, the deduction must be allocated among members of an affiliated group of corporations. The purpose of the small business provision, as noted in the Senate Finance Committee report in 1959, was "to aid new, small, and growing businesses" and to ensure that the increase in tax burdens in the 1959 Act would not "impede the growth of small and new life insurance companies."

TEFRA.—Although TEFRA increased the statutory amount in section 809(f) (as explained earlier), it made no change in the amount of the small business deduction.

Explanation of stock company position

Stock companies propose that the small business deduction, as defined in section 804(a)(3), be increased to allow a company a maximum deduction of $100,000. Such an increase is warranted in light of the extent of inflation since 1959.

In order to ensure that such deduction benefits only small companies, the deduction would be phased out and (as with existing law) would be subject to an affiliated group allocation. Under the phase-out, the $100,000 figure would be reduced (but not below zero) by 2.5 percent of the amount of the investment yield for the taxable year which exceeds $1 million. Thus, companies with an investment yield of $1 million would be entitled to the full amount of the deduction, while companies with more than $5 million in investment yield would not receive any benefit from the deduction.

CONSOLIDATED RETURNS

Prior law

Pre-TEFRA.—Under prior and present law, two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies.

Prior to TEFRA, for reporting purposes some taxpayers had taken the position that life insurance company taxable income is first to be determined for each component member of the affiliated group, and is then consolidated by adding those separate company taxable income bases. This approach, which is consistent with that followed by other (non-insurance) corporate taxpayers, is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as indicated in letter rulings, has been that the "taxable investment income" and the "gain from operations" of all life company affiliates must first be aggregated to arrive at consolidated group amounts, and then these aggregate amounts are utilized in determining consolidated life insurance company taxable income. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed by the Service on June 3, 1982,[3] with respect to consolidation of non-life and life companies, a "modified phase-by-phase" method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup, and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the section 809(f) limitation on policyholder dividends and "special" deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return occurs after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

TEFRA.—In TEFRA, Congress approved the "bottom line" consolidated method. Permitting such bottom line consolidation was consistent with prior Congressional policy and ensured that life insurance companies would be treated in a manner similar to most other corporations. Under the Act, for the taxable years 1982 and 1983, consolidated life insurance company taxable income will be determined by first computing the separate life insurance company taxable income for each affiliated company and then combining these amounts. The provision applies to the consolidation of affiliated domestic life insurance companies and to a life subgroup within an affiliated group. The TEFRA provisions do not affect the treatment of items computed on a consolidated basis which are not unique to life insurance companies (e.g., items such as charitable deductions will be subject to the general consolidated return rules applicable to all taxpayers).

In addition, Congress in TEFRA provided "grandfather" protection for companies that had taken the bottom line consolidated reporting position for taxable years beginning before 1982.

Explanation of stock company position

The stock company proposal would make permanent the bottom line consolidation provisions of TEFRA.

MENGE FORMULA

Prior law

Pre-TEFRA.—The 1959 Act allows each life insurance company to compute its "adjusted life insurance reserves" by application of a mechanical, arithmetic adjustment known as the "Menge" formula or "10-for-1" rule. This computation is then used in determining the policyholders' share of investment yield, and accordingly, affects the computation of a life insurance company's taxable investment income.

The Menge formula operates to reduce life insurance reserves (other than pension plan reserves) by 10 percent for each percentage point by which the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves. Its purpose is to restate such reserve amounts as they would have been had they been computed using the adjusted reserves rate.

TEFRA.—In 1982, Congress recognized that the Menge formula, which had worked well in the stable, low interest rate economy of the late 1950's, malfunctioned in the late 1970's and early 1980's due to substantial increases in interest rates. To correct this inaccuracy, Congress temporarily revised the Menge formula for the two-year "stopgap" period (1982 and 1983).

Specifically, under TEFRA the policyholders' share of investment yield is to be computed by using a "geometric" 10-for-1 rule to adjust statutory life reserves. Under this revised formula, the reserves are more accurately recomputed for tax purposes, by successively multiplying them by 0.9 for each percentage point by which the adjusted reserves rate exceeds the interest rate assumed in calculating the reserves.

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[3] Portions of the proposed regulations were published in final form on Mar. 18, 1983. However, provisions of the regulations relating to the determination of consolidated partial life insurance company taxable income were not finalized and are still in the proposed stage.

Explanation of stock company position

Stock companies propose to make permanent the "geometric" Menge formula introduced in TEFRA.

CONTRACT LIABILITY FOR GROUP PENSION CONTRACTS

Prior law

Pre-TEFRA.—Prior to TEFRA, life insurance companies were deemed to allocate investment yield to pension contracts on the basis of the current earnings rate, whether or not that rate exceeded the rate guaranteed under the contract. However, if the guaranteed rate of interest exceeded the current earnings rate, a taxpayer could allocate investment yield at the guaranteed rate rather than the current earnings rate by removing life contingencies from the contract.

TEFRA.—TEFRA provided that, for taxable years beginning after December 31, 1982, and ending before January 1, 1984, the policy or other contract liability requirements for group pension contracts, for purposes of determining the excludable policyholders' share of investment yield, will be limited to the amounts actually credited under the contracts (whether credited through premium rate computations, reserve increases, excess interest, experience rate credits, policyholder dividends, or otherwise). In general, this limitation applies on the basis of the total business for these contracts rather than on a policyholder-by-policyholder basis. Congressional intent was to allow a 100 percent deduction—no more and no less—for amounts credited on pension business by eliminating the so-called "double dip" available under prior law with respect to these contracts.

Explanation of stock company position

Stock companies propose to make permanent the TEFRA rule by limiting the exclusion for group pension contracts to the amounts actually credited to policyholders. As in TEFRA, the provision would also apply in the case of single premium group annuity contracts where interest is not explicitly credited each year but the premium or price is established primarily by competition. Under such contracts, the taxpayer would be allowed to take into account, as an amount credited to policyholders, interest based upon reasonable estimates reflecting the facts and circumstances involved in pricing the contracts.

LIFE INSURANCE COMPANY QUALIFICATION

Prior law

Pre-TEFRA.—Since 1921 the law has required that, to qualify a life insurance company for tax purposes, more than 50 percent of a company's "total reserves" must consist of life insurance reserves. At the time of the enactment of TEFRA, the Service was considering several ruling requests concerning the reserve treatment of amounts held under certain group pension contracts that do not involve life contingencies (i.e., that do not contain permanent annuity purchase rate guarantees). If these amounts (which are not life insurance reserves) were held to be includible in total reserves, then certain major life insurance companies might have been disqualified as life companies for tax purposes.

TEFRA.—Under TEFRA, for any taxable year ending before January 1, 1984, the status of a company as a life insurance company for tax purposes may not be changed solely because of the treatment of reserves for group pension contracts without permanent annuity purchase rate guarantees. Thus, companies which are commonly recognized as major life insurance companies were precluded from being reclassified and taxed as property/casualty companies.

Explanation of stock company position

The Stock Company proposal would make permanent the TEFRA rule by amending section 801(c) (relating to definition of total reserves) to provide that amounts held under pension and annuity contracts which do not contain permanent annuity purchase rate guarantees are excluded from total reserves.

FLEXIBLE PREMIUM LIFE INSURANCE CONTRACTS

Prior law

Pre-TEFRA.—Section 101(a)(1) provides that gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if the amounts are paid by reason of the death of the insured.

In recent years, life insurance companies have marketed flexible premium life insurance contracts (referred to as "universal life" or "adjustable life"). These contracts are similar in some respects to traditional whole life policies, but typically permit the policyholder to change the amount and timing of the premiums and the size of the death benefit as the policyholder's needs change.

In a letter ruling (January 23, 1981), the Internal Revenue Service concluded that the entire amount paid upon the death of the insured under a unversal life insurance policy is excluded from gross income as proceeds of a life insurance contract under section 101(a), even though the death benefit was not fixed in relation to the policy's cash value and, as a consequence, the pure insurance protection involvled might become relatively small. Subsequent to the letter ruling, however, the Service announced that it was reconsidering its position on such life insurance contracts.[4] Thus, at the time of the 1982 amendments, it was unclear whether such contracts would be treated as life insurance contracts for tax purposes.

TEFRA.—In TEFRA, Congress acted to ensure that the death benefit payable under a flexible premium life insurance policy would continue to be eligible for exclusion under section 101. However, in order to prevent such contracts from being overly investment oriented (i.e., allowing a large cash value build-up without requiring a continued reasonable amount of pure insurance protection), Congress provided for mandatory guidelines that flexible premium life insurance contracts must meet in order to be treated as life insurance for tax purposes. If these guidelines are violated at any time over the duration of the contract, it will not be treated as providing only life insurance for tax purposes. Rather, the contract may be treated as providing a combination of term life insurance with an annuity or a deposit fund (depending upon the terms of the policy).

Under the TEFRA provisions, a flexible premium life insurance contract is a life insurance contract which provides for the payment of one or more premiums that are not fixed by the company as to both timing and amount. In addition, the term "flexible premium contract" also includes contracts that provide for certain qualified additional benefits, specifically, family term insurance, accidental death benefits, waiver of premium benefits, and guaranted insurability benefits. However, such term does not include that portion of any contract which is treated under State law as providing annuity benefits (other than as a settlement option).

The mandatory guidelines contain two alternative tests which a contract must meet in order for the death proceeds therefrom to be treated as life insurance for tax purposes:

(A) The first test provides that two requirements must be met at all times: (1) the sum of the premiums paid under the contract at any time cannot exceed a specifically computed guideline premium limitation; and (2) the amounts payable on the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death.

(B) The second test is a cash value test patterned after a traditional whole life policy. That is, death proceeds paid from a flexible premium life insurance contract will be excluded from the beneficiary's gross income if, by the terms of the contract, the cash value may not exceed at any time the net single premium for the death benefit at such time.

In general, the TEFRA provisions regarding flexible premium life insurance contracts apply to all such contracts issued before January 1, 1984. The Act provided certain transition rules for contracts issued before January 1, 1983, and also provided that any death benefits paid within the first year of enactment under a flexible premium contract issued before January 1, 1983, are excluded from gross income whether or not the contract is in compliance with the guidelines.

Explanation of stock company position

Stock companies strongly support the flexible premium life insurance contract guidelines contained in TEFRA and propose that such guidelines be made permanent.

MEMBER ROSTER OF STOCK COMPANY INFORMATION GROUP

Aetna Life Insurance Company (Hartford, CT): Aetna Life Ins. & Annuity Co. (Hartford, CT); Aetna Life Ins. Co. of Illinois (Chicago, IL); Excelsior Life Ins. Co. (Toronto, Ont., Can.).

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[4] In a General Counsel's memorandum dated July 9, 1982 (and released to the public in December 1982), the Chief Counsel of the Service recommended that, particularly in light of the possibility that the pure insurance element could become very small, the policy be treated for tax purposes as if it combined two contracts, one providing for term insurance and the other providing for a deferred annuity.

Allstate Life Insurance Company (Northbrook, IL): Lincoln Benefit Life Co. (Lincoln, NE); Northbrook Life Ins. Co. (Northbrook, IL); Surety Life Ins. Co. (Salt Lake City, UT).

American General Life Insurance Co. (Houston, TX): Am. General Life Ins. Co. of Delaware (Houston, TX); Am. General Life Ins. Co. of New York (Syracuse, NY); Am. General Life Ins. Co. of Oklahoma (Okla. City, OK); California-Western States Life Ins. Co. (Sacramento, CA); Hawaiian Life Ins. Co. Ltd. (Honolulu, HI); Lincoln American Life Ins. Co. (Memphis, TN); Merit Life Ins. Co. (Evansville, IN); Pioneer Security Life Ins. Co. (Houston, TX); Variable Annuity Life Ins. Co. (Houston, TX); Life & Casualty Ins. Co. of Tennessee (Nashville, TN); National Public Serv. Ins. Co. (Seattle, WA).

Business Men's Assurance Company of America (Kansas City, MO): Assurance Life Co. (Kansas City, MO).

CNA Life and Annuity Company (Chicago, IL): Continental Assurance Co. (Chicago, IL); Mid-States Life Ins. Co. of America (Evanston, IL); Valley Forge Life Ins. Co. (Chicago, IL).

Capitol Holding Corporation (Louisville, KY): Commercial State Life Ins. Co. (Jefferson City, MO); Commonwealth Life Ins. Co. (Louisville, KY); Georgia International Life Ins. Co. (Atlanta, GA); Home Security Life Ins. Co. (Durham, NC); National Home Life Assurance Co. (Jefferson City, MO); National Home Life Assurance Co of New York (Binahamton, NY); National Liberty Life Ins. Co. (Frazer, PA); National Liberty Life Ins. Co. of America (Frazer, PA); National Standard Life Ins. Co. (Orlando, FL); Peoples Life Ins. Co. (Washington, D.C.); Veterans Life Ins. Co. (Springfield, IL).

Cigna (Hartford, CT): Connecticut General Life Ins. Co. (Hartford, CT); Educators Life Ins. Co. of America (Los Angeles, CA); Horace Mann Life Ins. Co. (Springfield, IL); INA Life Ins. Co. (Los Angeles, CA): INA Life Ins. Co. of New York (New York, NY); INA Standard Life Ins. Co. (Indianapolis, IN); Investors Life Ins. Co. of North America (Philadelphia, PA); Life Ins. Co. of North America (Philadelphia, PA); INA International Ins. Co. (Wilmington, DE); Master Life Ins. Co. (Ariz.) (Philadelphia, PA); Norton Life Ins. Co. (Phoenix, AZ).

E. F. Hutton Life Insurance Company (La Jolla, CA): New Century Life Ins. Co. (La Jolla, CA).

Federal Kemper Life Assurance Company (Long Grove, IL): Kemper Investors Life Ins. Co. (Chicago, IL).

Great Southern Life Insurance Company (Houston, TX): Guardsman Life Ins. Co. (W. Des Moines, IA); National Life & Accident Ins. Co. (Nashville, TN).

Hartford Life Insurance Company (Hartford, CT): Hartford Variable Annuity Life (Hartford, CT); ITT Life Ins. Corp. (Minneapolis, MN); Hartford Life & Accident Ins. Co. (Hartford, CT).

IDS Life Insurance Company (Minneapolis, MN): IDS Life Ins. Co. of New York (Albany, NY).

Integon Life Insurance Corporation (Winston-Salem, NC): Life of Mid-America Ins. Co. (Dubuque, IA); Victory Life Ins. Co. (Topeka, KS).

Jefferson Standard Life Insurance Company (Greensboro, NC): Great Eastern Life Ins. Co. (Columbia, SC); Jefferson Pilot Life Ins. Co. (Greensboro, NC); Jefferson Pilot Pension Life Ins. Co. (Greensboro, NC); Pilot Life Ins. Co. (Greensboro, NC).

Kansas City Life Insurance Company (Kansas City, MO): Armour Life Insurance Company (Kansas City, MO); Kansas City Life and Annuity Company (Kansas City, MO); National Reserve Life Insurance Company (Sioux Falls, SD); Sunset Life Sunset Company (Olympia, WA).

Liberty Life Insurance Company (Greenville, SC): Omni Life Ins. Co.; Orion Life Ins. Co.; United Fidelity Life Ins. Co. (Addison, TX).

Liberty National Life Insurance Company (Birmingham, AL): Rockford Life Ins. Co. (Rockford, IL); United American Ins. Co. (Dallas, TX); United Investors' Life Ins. Co. (Kansas City, MO); American Life & Accident Ins. Co. (Grand Prairie, TX); Globe Life & Accident Ins. Co. (Wilmington, DE); Globe Life & Accident Ins. Co. of Oklahoma (Oklahoma City, OK); International Financial Services Life Ins. Co. (Miami, FL).

Life Insurance Company of Virginia (Richmond, VA).

Lincoln National Life Insurance Company (Ft. Wayne, IN): Security-Connecticut Life Ins. Co. (Avon, CT); American States Life Ins. Co. (Indianapolis, IN); Dominion Life Assurance Co. (Waterloo, Ont., Can.); First Penn-Pacific Life Ins. Co. (Harrisburg, PA); Lincoln National Life Reinsur. Co. (Ft. Wayne, IN); Lincoln National Pension Ins. Co. (Ft. Wayne, IN).

Monumental Life Insurance Company (Baltimore, MD): Americana Life Ins. Co. (Dublin, OH); Monumental Natl Life Ins. Co. of New York (Buffalo, NY); United Re-public Life Ins. Co. (Harrisburg, PA); United Sun Life Ins. Co. (Mulberry, FL); Volunteer State Life Ins. Co. (Chattanooga, TN).

Paul Revere Life Insurance Company (Worcester, MA): Paul Revere Protective Life Insurance Company (Wilmington, DE); Paul Revere Variable Annuity Insurance Company (Worcester, MA).

Provident Life & Accident Insurance Company (Chattanooga, TN): Provident General Ins. Co.; Provident Life & Casualty Co. (Chattanooga, TN); Provident Natl Assurance Co. (Chattanooga, TN).

Southland Life Insurance Company (Dallas, TX).

Southwestern Life Insurance Company (Dallas, TX): Southwestern General Life Ins. Co. (Dallas, TX); Philadelphia American Life Ins. Co. (DE); Philadelphia Life Ins. Co. (Philadelphia, PA).

Transamerica Occidental Life Insurance Company (Los Angeles, CA): Arbor Life Ins. Co. (Phoenix, AZ); Transamerica Occidental Life Ins. Co. of Illinois (Chicago, IL); Transamerica Occidental Life Ins. Co. of Texas (Hye, TX); Transamerica Assurance Co. (Los Angeles, CA); Transamerica Life Ins. & Annuity Co. (Los Angeles, CA); Transamerica Ins. Corp. of California (Los Angeles, CA).

The Travelers Insurance Company (Hartford, CT): Keystone Mass. Life Ins. Co. (Boston, MA); Keystone Provident Life Ins. Co. (Boston, MA); Travelers Life & Annuity Co. (Hartford, CT); Travelers Life Ins. Co. (Hartford, CT); Travelers Ins. Co. of Illinois (Hartford, CT).

Washington National Insurance Company (Evanston, IL): Anchor Natl Life Ins. Co. (Los Angeles, CA); United Presidential Life Ins. Co. (Kokomo, IN); Washington Natl Life Ins. Co. of New York (New York, NY).

STATEMENT OF RAYMOND H. KIEFER, PRESIDENT, ALLSTATE LIFE INSURANCE CO.

Allstate Life Insurance Company appreciates the opportunity to comment on the very important subject of life insurance company taxation. Our interest is obvious: we want any ultimate legislation to be fair. That is, fair to our policyholders, fair to the company and fair to our stockholders. Legislation which does not meet that criteria will have far-reaching adverse implications for each group.

At the outset, we would like to express our total support for the positions enunciated by the Stock company Information Group at the hearings on May 11th. Because of the importance of this issue to us, we will supplement those views.

It is important that the subject of taxation of life insurance companies (and their policyholders) be examined in several contexts, that of: competiton within the broader financial services marketplace; competition within the life insurance industry itself; and, finally, in terms of the impact on consumers. We will, within these broad outlines, comment on the general policy considerations and other specific questions listed in the notice of these hearings.

COMPETITION WITHIN THE FINANCIAL SERVICES MARKETPLACE

While many commentators regard the new financial services marketplace as revolutionary, for those of us in the life insurance business it is really nothing new. It is more a matter of degree. We have always been in competition with the banks, thrifts and securities houses. The nature of that competition has changed over the years to reflect general economic conditions, but the competition has always been there. Over the years the securities dealers have tended to pursue our policyholders' accumulated cash values in life insurance policies with "buy term and invest the difference" approaches. The securities dealers seldom have created any new need for life insurance in the consumer's mind but have principally replaced existing policies. As to competition with banks and thrifts, it has always been clear that the differences in interest rates between life products and savings accounts and the availability of federal insurance guarantees made bank and thrift savings accounts economic alternatives to cash values of individual life policies. We have also seen the banks become fierce competitors in the pension and emloyee health benefit fields by promoting non-insured plans, thereby avoiding state premium taxes on health plans.

As new money interest rates rose, the impact of competition became even greater. The life insurance industry suffered dramatically from disintermediation as policyholders pursued the higher interest rates available from the banks' CD's and from money market mutual funds. Efforts by some life insurance companies to develop high interest rate, single premium deferred annuities resulted only in the ultimate flight of that annuity money as alternative investments with higher interest rates or lower acquisition costs became available. The life insurance industry has developed new interest-sensitive products in an effort to respond to these new competitive threats, only to be faced with a change in federal law permitting banks to issue insured money market accounts. That move gained the banks and thrifts billions of dollars in deposits, mostly at the expense of the money market mutual funds. There is no evidence that the new interest-sensitive life insurance products have produced a comparable drain either on bank accounts or money market mutual funds. On balance, life insurers have been the losers.

All during this time we have heard assertions and complaints that the life insurance industry was under-taxed and that life products had a tax-based competitive advantage over alternative products. If that were true one would expect the life insurance industry to have clearly outclassed its competitors in financial asset market share accretion or to have paid less in taxes than its competitors. Measured by share of financial assets held, the reality is that the banking and thrift industries' shares have held relatively steady while insurance companies have clearly lost market share. According to the 1982 Annual Report of the Minneapolis Federal reserve Bank, in 1959 the share of financial assets held by commercial banks was 41.6 percent, savings and loans 18.2 percent and all insurance companies 24.7 percent. By the end of 1981 those percentages stood at 37 percent for commercial banks, 23.1 percent for savings and loans and 16.9 percent for all insurance companies. (See Table 2 of the Appendix to the Federal Reserve Bank of Minneapolis 1982 Annual Report, a copy of which is attached as Exhibit A).

It is clear also from the General Accounting Office Report of September 18, 1981 (page 80), copy attached as Exhibit B, that during the period of 1960–1976 the life insurance industry was not undertaxed compared to banks in terms of taxes as a percentage of assets. From 1972 to 1976 life insurers paid more taxes in absolute dollars than did the banks. As of 1976 life insurers paid over five times what banks did in taxes in terms of percentages of assets. Viewed in another context, the life insurance industry's share of total corporate tax revenues went from 2.5 percent in 1959 to 4.2 percent in 1979. This is hardly an indication that life insurers are undertaxed, particularly in comparison to its competitors in the financial services marketplace.

In addition data published by the American Council of Life Insurance, based on U.S. Department of Commerce information, indicates that the individual life insurance share of the consumers' disposable income has been steadily decreasing for more than 40 years. In 1966, 2.7 percent of the consumers' disposable income was for individual life premiums. This dropped to 1.8 percent in 1981 and we understand (while not yet published) 1982 saw a further drop to 1.7 percent. These figures clearly indicate that the taxation of individual life insurance has not unduly influenced the marketplace nor disadvantaged our competitors.

So the marketplace doesn't reflect any advantage for life insurers either at the Company or product level. The more important point is: perhaps life insurance companies have been discriminated against over the years in comparison to their competitors in the financial services marketplace.

We, therefore, urge the Congress to deal with the taxation of life companies and its products in terms of marketplace reality and not be lead astray by perceptions or mere difference in tax law treatment. It is essential to the life insurance industry that it not leave this round of income tax deliberations in a worse competitive position in the financial services marketplace than that in which it entered the discussions. If the industry is competitively disadvantaged, our policyholders suffer as well.

Some have said that the above described performance by the life insurance industry suggests the industry should concentrate on selling pure protection. Or put another way, that consumers should only buy term insurance and invest the difference. We find that to be a very simplistic approach to consumers and their needs. It presumes a monolithic consumer. It ignores the differences between consumers, both financial and psychological. It presumes that consumers will have the willpower, the ability and the desire to invest. It also presumes that equivalent investment products will be readily available for all consumers regardless of income and asset base. It presumes there is no need or desire for life insurance beyond age 65. It presumes that consumers will be able to pay the ever-increasing cost of renewable term insurance in the later years and disregards the Veterans Administration experience with G.I. insurance in this respect. It presumes customers come from a cookie-cutter, and nothing is further from the truth. All these presumptions are easily overcome. However, our purpose here is not to argue the merits of permanent forms of life insurance vs. term insurance and "invest the difference" approaches. The point we wish to make is that tax laws should not determine the outcome of that debate. The marketplace should be the determinant. The ultimate fact is that the tax laws have not favored individual life insurance in terms of marketplace reality.

COMPETITION WITHIN THE LIFE INSURANCE INDUSTRY

It is important, as we pointed out earlier, that any ultimate life company income tax bill take careful measure of its impact on competition within the life insurance business. The reason is obvious. To the extent tax laws favor one segment of the business over another a competitive imbalance will immediately result. Tax laws should not interfere with the free workings of the marketplace nor create artificial advantages in that market. The 1959 Life Company Income Tax took specific cognizance of that fact. It did so by establishing a sound tax policy, one which recognized the essential differences between life insurers and other types of commercial enterprises. It also did so by taking account of the very different ways in which the various types of life insurers (mutuals and stocks) traditionally aggregated funds for use in years of adverse experience. And, more importantly, perhaps, in a competitive context, it found a way to ensure that the law would not interfere with the conditions of marketplaces at that time. (This obviously, must be a concern when any tax law is changed substantially.) It sought to preserve the prior relative tax burden between stocks and mutuals, so that the tax law did not become an instrument for competitive advantage for either.

The device chosen to preserve the balance in tax burden was the treatment accorded the deductibility of policyholder dividends under the tax laws. The question was then, and remains now, how does one measure or select a standard for determining the appropriate tax burden between stocks and mutuals, so as to preserve that competitive balance or neutral tax effect? There is probably no one statistic of a company that is perfectly correlated to its wealth producting potential. Assets is one potential measure. The GAO has used assets to compare the tax burden on life insurance companies and banks. It is also a factor which was chosen in 1959 to determine relative tax burden. Historical data split between stock and mutual insurers is available. However, mutuals now have stock life insurance subsidiaries whose assets are growing in significance and these should be included in the mutual share.

In 1959, the assets share of mutual companies was about 73.5 percent. The 1959 tax law was estimated to produce about a 75 percent share of tax burden for the mutual companies, slightly higher than its share of assets. Although the estimated share of taxes was not realized in 1958, through most of the 60's and 70's the mutual companies' share of taxes tracked slightly above their share of assets. In 1978, the last year not heavily influenced by Mod-co reinsurance or TEFRA, the mutual company share of tax was 62 percent and its share of assets was 61.5 percent.

A better measure, in our opinion, is the relative share of individual life insurance policy reserves because such policies have been the major profit producer for life insurers. Currently mutual insurers hold about 65 percent of such reserves. Historical data is not available, however.

From 1959 to recent years life insurance companies, whether organized as stocks or mutuals and whether small or large, have competed evenly for life insurance sales in the U.S. The large mutuals have grown larger and stock companies have grown too. But both large mutuals and large stocks have lost market share to the smaller companies. The fact that the trend of growth of stock companies compared to mutuals has occurred at a very gradual rate over the last 20 plus years, despite the very large number of new stock insurers, is strong evidence that the competitive balance between stocks and mutuals was not distorted by the 1959 Tax Act. That Act has permitted small insurers to be formed and to survive in a competitive market. These facts are strong support for the continuance of the fundamental principles contained in the 1959 Act. To search for some new way to achieve this balance introduces needless uncertainties in a very critical area.

Both Mod-co and TEFRA upset the competitive balance or neutrality of the tax law for life insurance companies. Both put stock companies at a competitive disadvantage because stocks paid more than a "neutral" share of the taxes. Mutuals have been able to react to this situation by paying higher policyholder dividends, making their products more competitive. (We saw this happen in 1982 when, by contrast, stock companies were reducing interest rates on universal life type products.) Since the tax burden was not adequately correlated to the share of the wealth of the market (e.g. individual life policy reserves), the mutual companies' share of taxes will never catch up with its share of the wealth of the market, unless the tax law is changed to restore that competitive balance. That is absolutely necessary in any new and permanent tax law.

With 77½ percent of dividends deductible the decrease in taxes for mutual companies from Mod-co or TEFRA will find its way into increased dividends which will, in turn, decrease future tax liabilities. And that begins another round of dividend increases resulting in more competitive advantage, lower taxes, etc.

We can, perhaps, understand the plight of the mutual companies under the 1959 Tax Act in an era of unprecedented high interest rates. We can see why they chose the "second-best" method—Mod-co—to relieve their burden. (However, we must "raise an eyebrow" at using Mod-co to reduce taxes to zero.) But TEFRA resolved the Mod-co problem and temporarily replaced the formula which was failing to reflect the high interest rates. We see nothing today to justify the mutual company desire to reverse the historic tax burden between mutuals and stocks—other than a desire for marketplace advantage.

TEFRA has, however, by providing a 77½ percent safety net deduction for dividends (100 percent for qualified pension dividends) produced a competitive imbalance and that advantage should not be perpetuated in this new tax legislation. Mod-co produced an aberration in income tax revenues as well as an aberration in competition. New tax legislation should return the industry to its pre-Mod-co balance and let the forces of the free market take over.

One way in which the pre-Mod-co balance could be obtained is through the continuation of the historic treatment of the deductibility of dividends by mutual companies. This is warranted by the fact that, as others have noted, the mutual company policyholder wears two hats, that of policyholder (a customer) and that of an owner of the enterprise. Some part of the insurance dividend is a distribution of corporate profits akin to distributions to shareholders in investor owned corporations. Those distributions ought to be treated comparably. Stock corporation dividends are taxed in the hands of the shareholder. Dividends to a mutual company policyholder are not taxed. The absence of equity is obvious. This difference was handled in the 1959 Life Company Income Tax Act by way of a limitation on the amount of policyholder dividends which could be deducted in calculating the mutual company income tax. We believe that continues to be the best way to handle the situation. The question is: where should that limitation be set? The 77¾ percent deduction provided by TEFRA is too high. It resulted in disproportionate tax treatment compared with stock companies issuing guaranteed cost contracts, as pointed out above. In our view, that limitation ought to be set at approximately 60 percent of dividends. That will help restore the marketplace balance which the 1959 Act recognized as desirable, which the industry agreed was desirable prior to TEFRA and which TEFRA failed to achieve.

Once having adopted the concept of balance, it is necessary then to look at the ways in which the effects of a realistic limitation on dividend deductions might be avoided. One of the most obvious would be for mutual insurers to form stock subsidiaries and transfer as much business into those companies as possible. (We are not convinced that insurance regulations, competition and the principles of mutuality will providentially work together to prevent this option. Rather we think competition and the principles of mutuality will encourage its use.) To prevent that method of tax avoidance, as well as to maintain as predictable a tax base as is possible, it will be necessary to tax stock subsidiaries of mutual companies as mutual companies. That would recognize substance over form in a manner consistent with existing tax policy. To do otherwise would result in a shrinking revenue base because mutual insurers could thereby avoid a major share of their proper tax burden. The same problem exists with respect to the level of deductibility of dividends in a mutual company. Grant them a 100 percent dividend deduction and their share of the tax burden will drop dramatically. In fact, with a 100 percent dividend deduction a mutual company taxes could be reduced to zero.

In the interest of improving competitive positions in the marketplace and balancing competition between insurers, it should be noted that the 1959 Act presents stock companies some impediment to entering the Group or Accident and Health lines in that earnings and losses, which may be volatile, have effects not anticipated. Price adjustments (premiums returned to customers) may not be deducted from gain from operations because of the Section 809(f) limit. This is especially incongruous because the refund is included in the income of the group policyholders. The deduction of 2 percent of premiums is not available to all stock companies. In fact, without modification, the 1959 Act may prevent use of the non-participating contract deduction for the individual life line in years when there are losses from group lines. These two deductions were intended to act in concert to provide necessary surplus margins due to the risk inherent in underwriting margins. These risks have grown with the intense competition in life and health insurance, especially in group markets. Removing the Section 809(f) limit, as it applies to stock company payments to customers, the non-participating contract deduction and the Group and A&H deduction would simplify the 1959 Act, remove an inequity with respect to payments to customers, as well as provide appropriate surplus accumulation for all stock companies.

FAIRNESS TO THE CONSUMER

The Subcommittee has asked: How much tax incentive, if any, should be associated with life insurance to assist the public in purchasing adequate protection? That question has to be viewed separately as respects death benefits and cash values.

As to death benefits, the better question, perhaps, is: What justification can be demonstrated for changing the law and subjecting death proceeds to income taxes? To do so would only add to the burdens of the Social Security System's survivors benefits because the voters would look to Social Security to make up the gap. Certainly, since Congress has chosen to exclude from income tax certain uninsured death benefit payments made by employers, it can hardly subject insurance death benefits, paid for by after tax dollars of the consumer, to income taxes. (Would you also then propose to tax insurance proceeds received to repair cars or rebuild houses in the event of a fire or windstorm?) National policy has always been to exclude such death proceeds from tax for the obvious reason that such insurance money diminishes the need for governmental and charitable contribution to the upkeep of widows and orphans. Such funds also play a role in educating children, who in turn become higher wage earners and larger tax payers. These funds also are builders of capital, which in turn produce taxable income. We consider this form of "tax incentive" to be a worthwhile "investment" by the Congress in: the production of future tax income; the encouragement of financial self-sufficiency; the amelioration of the hardships of widows and orphans; and the diminishment of demand on government for more social services. We can see no argument for taxing death proceeds that offsets the very real social values underlying the present tax law. Other forms of financial vehicles differ from life insurance in that they do not create the immediate estate that life insurance does. Therefore, they are not entitled to the same treatment.

Again, it would be worthwhile to look at this subject in the real world instead of in terms of tax theories. According to the 1982 Life Insurance Fact Book (page 14) published by the American Council of Life Insurance, total life insurance in force at the end of 1981 was equal only to 2 years of total disposable personal income per family. This figure has remained remarkably constant over the years. From this one might argue, in light of the very real social good served, that the existing tax laws provide too little incentive for the purchase of life insurance. In any event, it becomes clear that to tax death proceeds in any fashion would be to create a disincentive to life insurance purchases and cause considerable damage to the important social values it serves, as well as to the industry which provides that insurance.

As to accumulating cash values, there is considerable social value and equity involved in maintaining the present tax law. Those cash values are used for many purposes i.e., emergency cash in the event of unemployment or other hardship; education of children; and retirement income, to name a few. Most policyholders view their cash values as the "last resort" source of funds. Again, to provide a disincentive for the accumulation of such funds runs contrary to the same social policy described in the preceding paragraph. To the extent the funds are used for retirement purposes, the present tax treatment is consistent with Congressional policy in creating incentives for retirement savings, as others have pointed out. To change the existing law would be inequitable and inconsistent with that policy. And, as others have also pointed out, cash values of life insurance policies are taxed upon surrender (to the extent they exceed premiums paid). That, too, is consistent with social policy, for once the funds have ceased to be used for the purposes intended any gain should be taxed. Section 101(f) changes introduced by TEFRA appropriately address the situation where policies are purchased as "investments." Therefore, we see no good reason, social, economic or tax, to change the existing treatment of cash values—the inside build-up—other than to make Section 101(f) permanent.

There is yet another reason for the difference in tax treatment of the life insurance inside build-up as compared to the interest earnings on bank accounts or securities. Life insurance cash values are not "received" in the sense that bank account or other interest income is. It is not demand money. Insurers have the contractual right to delay or defer payment of cash values for up to six months, (Furthermore, the policyholder suffers a substantial detriment, loss of the insurance guarantee and its guaranteed premium, by surrending the policy for its cash value.) To tax the interest credited under such circumstances would be effectively to treat it as constructively received—a departure from traditional tax policy.

Therefore, we see the existing tax law as eminently fair to the consumer and consistent with long-standing national policy. Any changes can only harm the consumer and work contrary to other federal policy objectives. If Congress, in its wisdom, should decide to tax the "inside build-up", which we sincerely hope it does not, then the tax should be imposed at the policyholder level not at the Company level. That is the most equitable way to do so because the tax burden would be shared by the tax payers in a manner consistent with their individual circumstances, not on an arbitrary basis where some would be penalized and others favored.

OTHER CONSIDERATIONS

There have been some suggestions that the 1959 Life Insurance Company Tax Act is too complex and that a more simplified tax law would be desireable. We believe the 1959 Act is fairly simple conceptually. It certainly has the advantage of having been in use a long time, is understood by those who have to deal regularly with the subject, has produced, over the years, an ever-increasing amount of revenue and has generally worked well in principle. It does need fine-tuning to take account of new marketplace conditions. However, we believe any new suggestions must be viewed in the context of the fairness considerations mentioned earlier.

A number of possible alternatives have been exposed for comment over the years. One we have seen recently involves the "unbundling" of the life insurer, i.e., distinguishing between investment and underwriting income and treating each separately. The results of one segment would not be applied against the other in determining total tax liability. Only a 3 percent deduction would be allowed against investment income on products which are investment oriented, however that would be defined. It also contemplates some form of taxation on the policyholder (on the "inside build-up") either by way of a proxy tax or directly against the policyholder. We have previously commented on taxing the inside build-up so we will not repeat those comments here. Permit us to offer our preliminary comments on the balance of the concepts:

1. Simplification

The proposal is really not less complicated than the 1959 Act. It is still a three-part concept. There is still a need to determine what portion of the premium is underwriting and what portion "investment". This may have to be done on a policy-by-policy basis which would be expensive and require elaborate regulations. Manipulative tax planning would still be possible.

In addition, the arbitrary 3 percent of reserves credit will generate tax planning. The 3 percent is arbitrary because it does not in any way relate to the investment income assumptions being made in pricing products. Companies might be forced to increase premiums in order to minimize tax losses that could never be recovered. That would disadvantage the customer and make the life insurance industry less competitive in the financial services marketplace.

In order to produce fairness within the life insurance industry, it will be necessary to have different rules or tax rates for stocks and mutuals. This proposal does not obviate the need for balance between industry segments.

The tax calculations would also be made more complex by the necessity to split death proceeds to match the unbundling concept. What portion is attributable to interest credits which have already been taxed? You must know that in order to give the company the proper deduction from investment income.

2. Unfair to the life industry

This fact is evident from the following:

(*a*) The concept does not permit the results of the underwriting operation to be combined with the results of the investment operation in determining total taxable income. This is totally contradictory of existing tax policy for all other corporations. Not only can results from different businesses within a single corporation be combined in calculating taxable income, but disparate affiliated corporations are permitted to consolidate results. We can see no reason for treating the life insurance industry differently, particularly when the underwriting and investment operations are part of a single venture and product and are dependent upon one another. It should be obvious that this disparate treatment will disadvantage the life insurance industry in its ability to compete within the financial services marketplace. After all, banks, as an example, are not limited to deducting operating expenses only from service charges received.

This approach seems to stem from a belief that life insurers cannot lose money from either their investment or underwriting operations. Nothing could be farther from fact. Were that so there would be no need for insolvency guaranty associations under state law and Allstate, for one, would have been spared over $254,000 in contributions to such associations in 22 states over the last six years.

Because of this treatment insurers which experience underwriting losses, and most new insurance companies do so, would be required to make up those losses out of after-tax investment income or out of accumulated surplus. This would make the formation of new insurers very difficult if not impossible. Such an obstacle is contrary to good economic and anti-trust principles;

(*b*) No other industry pays a proxy tax for its customers;

(*c*) Freezing the tax-free inside build-up at archaic levels, while the industry's competitors are allowed to deduct current interest payments, will prevent the life industry from being able to compete for the customer's disposable income.

Therefore, this proposal is clearly contrary to the best interests of the life insurance industry and favors its competitors.

3. Unfair to stock insurers

While both stocks and mutuals would nominally be treated the same under this proposal, the effects on each are not the same. For example:

(a) Mutual insurers traditionally have written insurance at higher premiums than stock insurers. Stock insurers, on traditional policies, guarantee their cost of insurance while mutuals do not. Therefore, mutuals have a larger premium base within which to absorb underwriting expenses and can, by passing dividends back to their policyholders, arrive at zero underwriting income and in addition pass investment income back to their policyholders through the dividend process. That is not possible for stock insurers, so the inability to offset investment income and underwriting losses will fall hardest on stock insurers;

(b) The dividend process would also permit mutual companies to adjust their income so that tax loss carry-forwards from underwriting would not ever be likely to expire unused. The same cannot be said of stock companies. The ability to carry tax losses forward could be illusory for stock companies; and

(c) Part of the dividend to mutual policyholders is similar to a stockholder dividend, i.e. it is a payment to the owner of a company. Allowing a deduction for such policyholder dividend but not for a stockholder dividend would be an unsurmountable competitive disadvantage for the stock insurer.

Therefore, it is apparent that this proposal would not rectify the existing tax and competitive imbalance between stocks and mutuals. It would inflect punitive effects upon stock insurers.

4. Unfair to the consumer

To the extent that the tax law would contribute to the financial instability of an insurer or keep new insurers from entering the marketplace, it is obvious the consumer's best interests are not being served. In addition, stock insurers might have to cease issuing guaranteed cost products and issue participating policies instead. That would automatically cause increases in premiums for consumers and deprive them of the choice of a guaranteed cost or participating policy. Tax policy should not restrict market availability in this fashion. In many cases that increase in premium would mean less insurance protection purchased. The consumer does not have an unlimited amount of funds. For the same dollar amount of premium, same age and plan of insurance, Allstate's guaranteed cost premium will purchase about 30 percent more permanent insurance than most of its mutual company competitors. A tax bill which would have that structural effect is contrary to the public interest.

CONCLUSION

As noted at the outset, the ultimate tax bill for life insurers must be fair competitively within and without the insurance industry as well as fair to our policyholders. If the bill is not fair in comparison to our competitors for the public's financial security dollar, the government will have helped destroy the industry which has provided billion of dollars of security for the U.S. public and which has contributed so much to capital formation over the years. If the tax bill is not fair within the insurance industry itself, government will have helped destroy competition within the business. Finally, if the tax bill is not fair to the consumer, government will have created the worst cut of all. It will have penalized the public for its reliance on insurance as a means of creating and accumulating assets against the uncertain future.

We hope that the Subcommittee will receive our comments in the spirit in which they are offered—one of a sincere desire to be helpful and to contribute meaningfully to the Subcommittee' deliberations. We believe the tax proposal offered by the Stock Company Information Group, which we endorse, is a well-reasoned and practical approach to life company taxation and meets the criteria of fairness we established at the outset of this statement. Thank you for your attention to our comments.

EXHIBIT A

Table 2

Shares of Total Financial Assets Held by Financial Institutions[1]
Five-Year Moving Averages[2]
1956-1982
Percent

Year-End	Commercial Banks[3]	Savings Institutions[4]	Insurance Companies	Pension Funds	Other Financial[5]
1956	45.9	16.1	25.2	6.1	6.7
1957	44.4	16.9	25.1	6.7	7.0
1958	43.0	17.5	24.9	7.3	7.3
1959	41.6	18.2	24.7	7.9	7.6
1960	40.5	18.8	24.4	8.5	7.8
1961	39.4	19.3	24.0	9.1	8.1
1962	38.6	19.8	23.5	9.6	8.4
1963	37.9	20.4	23.1	10.0	8.7
1964	37.4	20.8	22.5	10.4	8.9
1965	37.1	21.2	21.8	10.8	9.1
1966	37.0	21.4	21.3	11.0	9.2
1967	36.9	21.4	20.8	11.5	9.5
1968	37.1	21.1	20.2	11.9	9.8
1969	37.3	20.8	19.8	12.1	10.0
1970	37.5	20.6	19.5	12.4	10.0
1971	37.6	20.6	19.0	12.7	10.1
1972	37.6	20.8	18.6	13.0	10.1
1973	38.0	21.1	18.1	12.9	9.9
1974	38.6	21.6	17.7	12.5	9.6
1975	39.1	22.2	17.3	12.3	9.3
1976	39.2	22.7	17.0	12.1	8.9
1977	39.3	23.4	17.0	11.7	8.6
1978	39.1	23.9	17.0	11.7	8.4
1979	38.3	24.2	17.0	11.9	8.5
1980	37.8	24.2	17.1	12.1	8.9
1981	37.5	23.7	17.0	12.1	9.7
1982[6]	37.0	23.1	16.9	12.3	10.7

1/ Includes credit market debt claims against nonfinancial sectors (Table 1), plus currency, demand and time deposits, security credit, corporate equities, member bank reserves, and miscellaneous assets.

2/ The year shown is the final year in the five-year moving average.

3/ Consists of U.S. chartered banks, domestic bank affiliates, Edge Act corporations, agencies and branches of foreign banks, and banks in U.S. possessions. Does not include nonbank affiliates of bank holding companies or foreign affiliates of U.S. chartered banks.

4/ Consists of savings and loan associations, savings banks, and credit unions.

5/ Consists of finance companies, real estate investment trusts, open-end investment companies, money market funds, and security brokers and dealers.

6/ End of third quarter.

Source of basic data: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding.

Table 2 shows total financial assets of all kinds held by financial intermediaries, a somewhat broader credit aggregate than in Table 1. These assets include holdings of debt claims against nonfinancial sectors (as in Table 1) plus holdings of currency, demand and time deposits, security credit, corporate equities, and member bank reserves. The data in Table 2, therefore, do not net out intermediaries' credits to one another.

According to this measure, commercial banks lost market share until 1967 and, after that, maintained a relatively constant share of around 37 percent. The early loss of bank share went primarily to thrift institutions and to pension funds. During the 1950s and early 1960s, commercial banks were funding a substantial proportion of loan demand by reducing the proportion of financial assets held as cash reserves and as government securities (partly due to reductions in required reserves); thus, they did not aggressively seek new sources of funds. The situation changed in the mid-1960s and later, however, as banks increasingly became aggressive liability managers. Over the entire three-decade period, insurance companies lost share, and pension funds gained.

EXHIBIT B

TABLE 17.—Comparative Income Tax Burdens of Life Insurance Companies and Banks

[Dollars in thousands]

Year	Life insurance companies		Banks	
	As percent of all life companies' assets	Income taxes before credits	As percent of all bank's assets	Income taxes before credits
1976	0.66	$2,119,001	0.13	$1,779,916
1975	.66	1,918,644	.12	1,503,334
1974	.70	1,883,107	.13	1,578,659
1973	.69	1,754,849	.14	1,529,419
1972	.64	1,550,125	.14	1,307,908
1971	.58	1,300,054	.18	1,412,488
1970	.60	1,250,774	.23	1,575,839
1965	.47	760,941	.22	973,395
1960	.44	529,409	.45	1,363,459

Chairman **Stark**. Thank you very much.

I must apologize, Mr. Lebed, both on the witness list and on the name card, which you can't see but which we are all staring at, we have added an extra "d", to your name. I would want to correct that and say that I believe the correct spelling is L-e-b-e-d, and it is pronounced Lu-bed.

Mr. **Lebed**. That is correct. I apologize, it is not the first time it has ever been misspelled.

Chairman **Stark**. You have covered an awful lot of territory in your prepared testimony and also in your summary. I will just hop around. There are a couple of things I want to cover and I am sure other members will cover other areas.

You have prepared a proposal and presented us with some revenue estimates in that. Have any of the panel members measured that proposal against your own companies?

Mr. Turner, it is my understanding that last year Life Insurance Co. of Virginia paid no taxes. The question is, would they, under the proposal that the Stock Company Information Group puts forward, pay any taxes?

Mr. **Turner**. We have not made such a measurement for our company. I will be glad to respond to the implication, if you would like.

Chairman **Stark**. I am quite serious. I don't know what this does to stock companies.

Mr. **Kiefer**. We can give you some revenue estimates within the industry between stocks and——

Chairman **Stark**. But none of you know exactly what it would do in the microsense to any of your individual companies.

Let me then ask the question. You do suggest that your proposals would raise $2.6 billion. As you know, this is over $1 billion less than we projected as a result of TEFRA, and that the budget anticipates we will be receiving. Is there a justification for reducing the amount of taxes that we currently anticipate receiving from the industry?

Mr. **Kiefer**. I wonder if I could comment on that with a positioning of where we are coming from that relates to the competitive position of our industry vis-a-vis other competitors, not just internal equity between stocks and mutuals, but some of the realities of the marketplace that have to do with the life company.

This is kind of critical for us because——

Chairman **Stark**. Mr. Kiefer, that is a valid point, but it really is in a sense not before this subcommittee, as much as we wish we could be charged with making those economic decisions.

If we could agree ourselves, or the industry and this committee, on a method to be used in raising revenue through taxing life insurance companies, then we could have the discussion of your tax burden relative to that of the banking industry, or relative to that of other financial intermediaries. I still want to hear your answer, but I just want to point out that we have so much to do before we even get to that discussion.

I am sure there will be a long, involved discussion on that, and I say that mostly for other witnesses who may discuss that. We don't even quite know how to get to whatever figure you and I might agree on ought to be paid as your fair share.

Mr. **Kiefer**. I understand. I just want to make the point we don't want to come out disadvantaged any more than what we think we already are.

Chairman **Stark**. I just have one final question of Mr. Lebed. In the special deductions for the deferral of underwriting income, it is my feeling confirmed by those few people I can find that were around then, that the 1959 act was a compromise in which for the first time we were taxing underwriting income. As a method of softening the transition, the 50 percent deferral was made available. Has there been any experience in the limited number of companies who use it that this surplus is necessary for any other reason than balancing the tax burden within the industry?

Have there been any catastrophic losses that it has covered? Baldwin United may be an example coming up, but until that happens, is there any real reason other than as a balancing mechanism between segments for the deferral to be there?

Mr. **Lebed**. Yes, sir, there are some rather substantive business reasons for that. These deferrals go into a so-called policyholder's surplus account, which is part of our overall surplus to protect policyholders. Many companies have had to dip into their surplus again and again for various reasons because of unusual losses or bad experiences. Some companies even would have gone insolvent were it not for the surplus or their ability to call on other companies.

Now, one problem that exists that I think isn't well understood is that there is no way to take money specifically from the policyholders' surplus account to apply it to offset losses without paying tax on that money. Therefore, from an accounting point of view, you will never see money coming out of the policyholders' surplus account, even though there are losses being incurred and the need to dip into surplus.

Chairman **Stark**. Our time is up, but I want to make one final comment there. This committee also is not charged with the safety of the policyholders' contract. That is a matter for the various

State commissioners. If we were charged with determining the proper amount of surplus necessary to protect the policyholders, it would be incumbent on the Congress to lay down some regulations about how the business operates. I think that is an area that we both agree we want to stay out of.

Mr. **Turner**. I think, with all due respect, you don't want tax policy to act contrary to those sorts of principles—that is, safety and protection of policyholders

Chairman **Stark**. We only tax profits. If a company is obeying its State regulation, which I trust deals adequately with the safety of the policyholder, then the only part we tax is that profit which belongs to the shareholders and not to the policyholders.

Mr. **Lebed**. Mr. Chairman, I would go back to my main point, that what we have now is a balanced approach to the taxation of underwriting profits for mutual and stock companies.

Chairman **Stark**. So it is a balancing tool primarily in your eyes?

Mr. **Lebed**. It is primarily a balancing tool, but it does serve a very useful purpose for policyholder protection.

Chairman **Stark**. Mr. Schulze will inquire.

Mr. **Schulze**. Thank you, Mr. Chairman.

Mr. Kiefer, when you said you don't want to be disadvantaged any more than you are, were you referring to stocks versus mutuals or the insurance industry versus other——

Mr. **Kiefer**. I was referring to the insurance industry versus other financial intermediaries.

Mr. **Schulze**. That is a question I would like to get to. It has been stated that you have an advantage. You inferred that there is a disadvantage.

Mr. **Kiefer**. If I could take a minute to explain my point, I would be happy to.

Competition between insurance companies, between life insurance companies and brokerage houses and between such companies and the commercials and thrifts is a longstanding one, and I think it is changing rapidly as the circumstances change around us. I think there are some perceptions, though, that I would like to clarify in terms of what is happening to our ability to compete in this area.

And I think one of the first places we start is if we take a look at probably our strongest competitor for the savings element which is the commercials and thrifts. The statistics, the most recent ones I have seen, indicate that in 1959 commercials and thrifts had about 59 percent of the financial assets of this country under management, and the insurance industry had about 25 percent of those assets.

As of 1981, the commercials and the thrifts still have about 60 percent of those assets under management. However, the insurance industry is now at 17 percent, or we have lost one-third of those assets during that period of time.

The GAO in September of 1981 published a report that said that in the period 1972 to 1976, the insurance industry paid more absolute dollars in taxes than did the commercials and thrifts. As a matter of fact, in 1976 we paid five times the amount of taxes that those institutions paid in terms of percentages of assets.

And I think if you carry this a little further and you look at what is happening in our competition for the consumer's disposable income dollar, you will find that from 1966 to 1981 the life insurance industry used to get 2.7 percent of the disposable income dollar for the purchase of ordinary life by the average family in the United States. By 1981, that had been reduced to 1.7 percent, or we have lost one-third of that disposable income dollar.

The point we are making is that it appears that we are paying more taxes, and yet we are losing market share, and as we talk about new products that are being developed in our industry, one of the assumptions you could make is that these products are helping us gather in more of that disposable income dollar.

However, there are no facts to support this. In fact, we are not making those gains, and we are paying more taxes in the process. So I think there is a legitimate question as to whether we are tax advantaged or tax disadvantaged in our ability to compete.

Mr. **SCHULZE**. So that, in effect, these new products are the leveling of the playing field, or your attempt to level.

Mr. **KIEFER**. The attempt on our part to get back into the ball game. Our point is, we have been taken out. We also find, incidentally, banks today competing very aggressively in the pension and in the health business through noninsured plans which avoid the State premium taxes, and I think it is important to know that our industry in 1981 paid $1.9 billion to State and local taxes.

Mr. **SCHULZE**. I am also concerned about how changes in the Federal tax law may impact on the solvency of life insurance companies. To what extent does the tax deferred contingency reserve account buttress against insolvencies or bankruptcies, and who would pay if we had increased bankruptcies in the life insurance industry?

Mr. **KIEFER**. Unfortunately, we are paying in that circumstance. I don't have the numbers with me, but I would be happy to provide what in fact we have paid in the last few years on insolvencies through contingency funds.

Mr. **SCHULZE**. What do you mean by "we?"

Mr. **TURNER**. I might clarify the point by observing that the general mechanism for covering the risk of insolvency in our business is for the most part a series of State guaranty associations; for a particular company in a State or a particular segment of business in a State, if it happens to go sour and turn insolvent, it has been the responsibility of the other members of that association, that is, Allstate, Life of Virginia, Aetna, and the others to bail that company out.

Mr. **LEBED**. May I add to that, Mr. Schulze. For stock companies, clearly, I think this applies to mutual companies too, the first line of defense against insolvency is the company surplus. The deferrals that go into the policyholders' surplus account are a very important part of that which I think was a part of your question.

Mr. **TURNER**. I think you see really a two-layered approach. The first is a stringent discipline at the policy or company level for solvency and financial soundness; that is, the way you strike your balance sheet; and, second, behind that you have an interindustry mechanism that stands in place to bail out troubled situations. We are one of the few major financial service industries that isn't backed up by federally insured programs.

Mr. **Schulze**. That is a formal structure?

Mr. **Turner**. Yes.

Mr. **Schulze**. Thank you.

Thank you, Mr. Chairman.

[The following was subequently received:]

Sutherland, Asbill & Brennan,
Washington, D.C. May 26, 1983.

Representative Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Washington, D.C.

Dear Mr. Chairman: On behalf of our client, the Stock Company Information Group, we request that the following supplemental information be made a part of the official record for the May 10 and 11 hearings of your Select Revenue Measures Subcommittee. First, a question was raised by Representative Richard T. Schultze to Raymond T. Kiefer, speaking on behalf of the Stock Information Group, regarding the amount of state guarantee fund assessments made in the past few years. In response to this question, assessments totaling approximately $70 million have been made since 1975 with regard to thirty life insurance companies which became insolvent during that time period.

In addition, we have attached three appendices which clarify several points raised during the hearing pertaining to taxes paid by the life insurance industry.

Appendix A provides an analysis of the tax to asset ratio for specific industry groups. This is in response to remarks made during the hearing which addressed the tax to asset ratio as a measure of the relative tax burden of specific industry groups. It should be noted that while the overall corporate tax to asset ratio has decreased by 38 percent over the past twenty years, the ratio for the life insurance industry has increased over 75 percent during the same period. Moreover, the ratio for the life insurance group compares favorably with that of other financial intermediaries (such as banks) and capital intensive groups (such as utilities).

Appendix B provides an analysis of corporations reporting net income for selected years. It should be noted that the life insurance industry has a higher percentage of companies which report net income than the overall corporate average.

Appendix C illustrates the relative corporate tax burdens of the life insurance, banking and electric utility industry groups expressed as a percentage of total corporate taxes paid. Of the three industry groups listed, the life insurance industry bears the largest tax burden on both a percentage and absolute dollar basis. Morover, the life insurance industry has paid an ever-increasing percentage of the corporate tax burden over the last twenty years, which contrasts with the performance of the banking and utility industries during the same time period.

We would be willing to work with you or your staff if you have any additional questions regarding our studies, or if you desire any additional information on the life insurance industry.

Sincerely,

William B. Harman, Jr.

APPENDIX A.—TAX TO ASSET RATIO

[Dollars in millions]

	Total assets	Total tax	Percent of total/assets
ALL INDUSTRIES [1]			
1978	$6,014,452	$64,387	1.10
1974	4,016,467	41,131	1.00
1970	2,634,707	27,878	1.10
1962	1,388,127	23,097	1.70
1960	1,206,662	21,866	1.80

Note.—The data for all appendixes were obtained from the Corporate Statistics of Income, published periodically by the Internal Revenue Service.

APPENDIX A.—TAX TO ASSET RATIO—Continued

[Dollars in millions]

	Total assets	Total tax	Percent of total/assets
LIFE INSURANCE [2]			
1978	389,924	[2] 2,772	.70
1974	263,349	[2] 1,768	.70
1970	207,154	1,183	.60
1962	133,291	[3] 620	.50
1960	119,576	[2] 479	.40
BANKS			
1978	1,725,421	1,828	.11
1974	1,176,588	963	.08
1970	688,018	1,409	.20
1962	351,497	1,170	.30
1960	303,986	1,363	.40
ELECTRIC, GAS, AND SANITARY SERVICE			
1978	267,506	1,953	.70
1974	198,270	1,247	.60
1970	123,913	1,589	1.30
1962	70,236	1,726	2.50
1960	63,229	1,598	2.50

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[1] Unless otherwise indicated, all figures derived from Statistics of Income published by the Internal Revenue Service for the particular year.
[2] Derived from 1982 Life Insurance Fact Book.
[3] Estimated.

APPENDIX B.—CORPORATION REPORTING A NET INCOME FOR SELECTED YEARS

	Total returns filed	Returns with net income	Percentage with net income
ALL INDUSTRIES			
1978	2,376,779	1,523,648	64.1
1974	1,965,894	1,207,396	61.4
1970	1,665,477	1,008,337	60.5
1962	1,268,042	783,195	61.8
1960	1,140,574	670,239	58.8
LIFE INSURANCE			
1978	1,798	1,306	72.6
1974	1,718	1,135	66.1
1970	1,795	1,014	56.5
1962 [1]	4,316	2,880	66.7
1960	1,732	868	50.1
BANKING			
1978	15,347	13,111	85.4
1974	14,534	12,030	82.8
1970	15,042	13,559	90.1
1962	14,818	13,706	92.5
1960	15,205	14,074	92.6
ELECTRIC, GAS, AND SANITARY SERVICE			
1978	12,494	7,172	57.4
1974	8,710	5,144	59.1
1970	6,823	4,121	60.4
1962	1,951	1,419	72.7
1960	1,299	986	75.9

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[1] Includes all insurance carriers.

APPENDIX C.—INDUSTRY SEGMENT SHARE OF CORPORATE TAX BURDEN

[Dollars in millions]

	Total corporate tax	Life insurance tax	Percentage of total corporate tax
1978	$64,387	$2,772	4.3
1974	41,131	1,768	4.3
1970	27,878	1,183	4.2
1962	23,097	[1] 620	2.7
1960	21,866	4[illegible]9	2.2

[1] Estimated.

BANKS

[Dollars in millions]

	Total corporate tax	Bank taxes	Percentage of total corporate tax
1978	$64,387	$1,828	2.8
1974	41,131	963	2.3
1970	27,878	1,409	5.1
1962	23,097	1,170	5.1
1960	21,866	1,363	6.2

ELECTRIC, GAS, AND SANITARY SYSTEMS

[Dollars in millions]

	Total corporate tax	Electric and gas	Percentage of total corporate tax
1978	$64,387	$1,953	3.1
1974	41,131	1,247	3.8
1970	27,878	1,589	5.7
1962	23,097	1,726	7.5
1960	21,866	1,598	7.3

Mr. GUARINI [presiding]. Mr. Dorgan, please.

Mr. DORGAN. Thank you, Mr. Chairman.

I would like to ask Mr. Lebed to amplify a statement you made on page 23 of your testimony. It seems to me that the question of a level playing field—that is a term that has continued to be used by people who testify and also by people on the committee, and an important one. I am not sure that everybody is clear about what a level playing field means.

There certainly doesn't seem to be any uniform agreement about that between the mutuals and the stock companies. I asked the mutuals yesterday about the treatment of dividends and how they saw dividends with respect to the concept of economic profit and so on.

At the bottom of page 23, Mr. Lebed, you state that "Dividends paid by mutual life companies simultaneously operate to distribute corporate profits from the corporation to its owners."

You are taking a position completely opposite the position taken yesterday by the mutual companies. You are suggesting that the dividends represent a form of economic profit to the entity, is that correct?

Mr. LEBED. I am suggesting that the dividend represents two things. Part of it is a policyholder or customer rebate, which is not an ownership return; but part of it is a return to the owners of the corporation, who are the policyholders.

Mr. DORGAN. I assume that you are saying that the failure to treat it that way means that you don't have a level playing field.

Mr. LEBED. Absolutely. If stock life insurance companies are paying dividends to their shareholders, and not being able to take a tax deduction for them and having their shareholders also pay a tax, we are in a far different ball game than a competitor would be if he is paying returns to his owners, taking a full deduction for those returns, and on which his owners don't have to pay any tax. That is what the situation would be if part of the mutual company dividend were not treated as an ownership return.

Sam, perhaps you would want to elaborate on that.

Mr. TURNER. There are several ways to respond to that. Probably one of the most significant issues to be addressed in overall tax policy, at least particularly within our industry, is the issue of stocks versus mutuals. The point of ownership is one where very clearly the level playing field would be either to tax the owner of a mutual company as such or equivalently to permit deductibility of shareholder dividends at the stock company level and not make them taxable to the recipient.

There are some other issues that are involved. For example, you get into competitive balance within the industry. To respond directly, I think that would be the extension of the argument.

Mr. DORGAN. This question is addressed to any of the three. Do you believe that the stock insurance companies are overtaxed at the present time?

Mr. KIEFER. The consensus within the industry on the deliberations on the stopgap proposal was that the industry would seek a 60–40 split between stocks and mutuals—60 percent for mutuals.

As Hank testified, and I feel very strongly personally about this, the stocks were disadvantaged under stopgap, with the 77½-percent deduction that mutuals were allowed, and I think the realities of the situation are if you will look at 1982, that we are probably coming closer to a 50–50 split in those taxes and yes, we are disadvantaged vis-a-vis the mutuals.

Mr. LEBED. Mr. Dorgan, you might be interested to know that the effective tax rate of stock life insurance companies is somewhere between 15 and 20 percent. The list of industries whose effective tax rates are well below that is quite long and includes other financial industries.

Mr. DORGAN. Mr. Lebed, were you here yesterday listening to the testimony of the mutual companies?

Mr. LEBED. Yes.

Mr. DORGAN. In several instances the question was raised about the accumulation of $9 billion of untaxed moneys that the stock companies possess and have not had a tax consequence.

How do you respond to that in terms of equity and also in terms of effective tax rate?

Mr. Lebed. I tried to cover that point in my prepared remarks, and I would simply repeat that the 1959 act has a balanced situation between no tax whatsoever on the underwriting profits of mutual companies and deferrals of tax on some of the underwriting income of stock companies. It is the accumulation of those deferrals over 25 years that has been added up to a figure of $9 billion.

I can't confirm whether that is right or not. I did make the point to the chairman and I would repeat it, that there is no mechanism to take money out of those deferred policyholder surplus accounts. Thus, when there are actual losses, which those have been designed to help you to protect, the money never comes out of those accounts. It comes from someplace else, and you have a very artificial accumulation there.

Mr. Turner. I don't think you were here when Mr. Lebed presented his prepared remarks. The point made was that the portion of untaxed gain from operations in the mutuals is significantly in excess of $9 billion, probably a rather large multiple of it, and the point was also made that, whereas the matter regarding the $9 billion was noted yesterday, we didn't hear anything at all about the mutual companies' untaxed gain from operations significantly in excess of that.

Mr. Dorgan. Can I just follow upon the answer you gave me with respect to the effective tax rate. That is a measure against what description of income?

Mr. Lebed. What we would call GAAP income, is that what you are referring to?

Mr. Dorgan. There is book income, several different incomes.

Mr. Lebed. I am not an accounting technician.

Mr. Dorgan. I am just trying to get a frame of reference that both of us understand.

Mr. Lebed. You take our taxable income base of all the stock companies, and the tax dollars actually paid over the years, the effective rate has averaged somewhere between 15 and 20 percent, and that number compares to I think something like 2 percent for commercial banks and many, many other industries are well below that.

Mr. Dorgan. Let me visit with somebody to see if we have an understanding that we are using the same base in measuring effective tax rates of banks versus taxable income of the stock company.

I raised a question with the mutuals yesterday. It is very difficult to get at the question of what is the effective tax rate of the life insurance industry and more specifically of mutuals vis-a-vis——

Mr. Lebed. Mr. Dorgan, we would be very happy to submit a detailed explanation of that.

Mr. Dorgan. I would appreciate it if you would.

I walked in at the middle of your testimony. That is the reason I asked apparently about something you had covered in your testimony. You have covered a great deal in your testimony. We appreciate your appearing. Your testimony is very instructive. Thank you.

[The following was subsequently received:]

SUTHERLAND, ASBILL & BRENNAN,
Washington, D.C., May 27, 1983.

Representative FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, House Ways and Means Committee, Washington, D.C.

DEAR MR. CHAIRMAN: In response to a question raised by Representative Byron L. Dorgan, presented below is a detailed explanation of the methodology used by our client, the Stock Information Group (SIG), in determining the effective tax rates of stock life insurance companies.

In general, the methodology used closely follows that used by the Joint Committee on Taxation, and "Tax Analysts". The data from which the effective rates are derived is contained in the Form 10K reports and annual statements required to be prepared annually by the Securities and Exchange Commission. The 10K reports, however, do not isolate the results of "life insurance companies".

In determining the net income for purposes of the effective rate calculation, several adjustments are made to net income before taxes as reported in the financial statements.

(1) Elimination of non-life subsidiaries.—Only the net income earned by subsidiaries taxed under section 802 of the Internal Revenue Code is used in the calculation. All results from non-life subsidiaries are excluded.

(2) Consolidation of subsidiaries.—Net income per the financial statements is adjusted to reflect the income or loss attributable to minority interests. However, in the case of life insurance subsidiaries the adjustment is insignificant.

(3) Equity accounting for investments in affiliate and joint returns.—Normally a company's income tax provision does not include taxes attributable to joint ventures. In the case of life insurance subsidaries these amounts are insignificant and therefore no adjustment is made.

(4) Extraordinary gains and losses.—To reflect the tax burden of the ongoing continuing operations, the income or loss attributable to extraordinary events is removed from the income figure.

(5) Securities transactions and capital gains.—Net income is adjusted to reflect securities transactions and capital gains which are reported separately.

(6) State income taxes are included in the net income figure.—This differs from the Joint Committee and Tax Analysts methodology. The amount of state income taxes with respect to life insurance companies is insignificant and thus does not materially affect the effective tax rate of such companies.

(7) Foreign income.—Foreign income is included in the income base. However, foreign income with respect to U.S. life insurance companies is insignificant and thus will not materially affect the effective tax rate.

The adjusted net income figure arrived at above is the denominator in the effective tax rate fraction. The numerator, as in the Joint Committee study, is current U.S. taxes as reported to shareholders. For consistency with the Joint Committee study, no deferred taxes are included. The numerator of the effective tax rate fraction includes U.S., state and local, and foreign taxes reported as currently paid reduced by foreign and investment tax credits.

The inclusion of foreign income in the denominator and exclusion of foreign taxes from the numerator was an expedient approach that slightly understates the effective tax rate. That is, strict adherence to the Joint Committee approach would produce higher effective tax rates.

We hope this brief explanation has answered the question regarding our effective tax rate calculation. We would be pleased to provide additional information or to work directly with the members of the Subcommittee and its staff in answering any questions regarding the effective tax rate calculations.

Sincerely,

WILLIAM B. HARMAN, Jr.

Chairman STARK. Mrs. Kennelly.

Mrs. KENNELLY. Mr. Lebed, it has become obvious that many insurance policies have become short-term investment vehicles. Do you think it would be fair tax policy if we looked at the new products and decided that the policyholder would be limited in his ability to borrow from these new products?

Mr. LEBED. Mr. Chapoton made that proposal yesterday. Frankly, that was a new idea to us, and we really haven't thought that one through. Our knee jerk reaction to any proposal that puts more limitations on our customers is not too positive, but we really need more time to evaluate that.

Mrs. KENNELLY. Would you work with the committee on this suggestion?

Mr. LEBED. We would certainly be delighted to. I would just reiterate, Mrs. Kennelly, what I said in my opening remarks, that we are very much in favor of appropriate legislation to make sure that life insurance policies are not being used as tax favored investment vehicles but rather as life insurance.

Mrs. KENNELLY. I have another question on this. If we could agree on guidelines to do this, do you think that the new policies which fit within the guidelines deserve to be taxed?

Mr. TURNER. Might I respond to that? Yesterday we received oral testimony that could have created the impression that Treasury was dissatisfied with what is referred to as 101(f), and generally proposed scrapping it and starting over.

As evidenced by comments this morning, some of the members of this committee may have received that impression. I would first note that the current definitional guidelines regarding life insurance relate only to certain flexible premium life insurance plans, such as universal.

Second, I think that the purpose of those guidelines and the accurate position of Treasury is very clearly set forth, I believe, on page 14 of Secretary Chapoton's statement. I would like, with your permission, to read it. It is very short.

> The first attempt to limit the investment orientation of life insurance contracts was made in section 101(f), added by TEFRA which deals only with "flexible premium life insurance contracts" such as universal life.
>
> Section 101(f) is a temporary measure designed to allow sellers of universal life insurance to compete on an equal basis with sellers of more traditional policies while providing some limits on the extent to which universal life could be used as an investment vehicle.
>
> Hence, the precise combination of limitations contained in this statute may not be appropriate for a permanent general definition of life insurance. For example, we believe that it is appropriate to examine whether single premium policies and policies which endow at an early age should be treated as life insurance for tax purposes.
>
> Nevertheless, the requirements contained in section 101(f) give some indication of the kinds of tests which might be incorporated into such a definition.

Quite simply, 101(f) defined the usage of universal life to conform to the historical usages of other products. Therefore, one must suspect that current abuses would most likely lie outside of those guidelines; that is, products that are not subject to specific statutory guidelines.

The position of the Treasury is quite clear that they are satisfied with the form of 101(f) and have raised the issue of whether the limitations reflected in 101(f) are adequate.

Our position, quite simply, is that universal life is enjoying only the extent of usage enjoyed by any traditional life insurance product on the market as demonstrated by historical usage, and if certain historical usages of life insurance are to be defined away as a matter of policy, then most certainly we would expect changes in 101(f) to conform. Again, 101(f) is the first statutory definition of life insurance: Every universal life policy sold complies with it. The intent, as specifically stated by Secretary Chapoton, is to permit its use only to the extent of the historical usage of traditional products. We would not suggest any different treatment for the universal life form of policy, a very consumer-oriented form than traditional. We would seek only the same treatment.

Mrs. **KENNELLY**. Yesterday we were told the 1959 act should be repealed. Today you tell us that you don't think it should be repealed, it should be worked with. Can we agree, at least, that we should leave the inside buildup alone?

Mr. **KIEFER**. Unless it can be determined that it is not a life insurance contract.

Mrs. **KENNELLY**. So we are back again to what is a life insurance policy?

Mr. **LEBED**. There is a need to define life insurance. Within the definition the inside buildup should be left alone.

Mrs. **KENNELLY**. Let me go one step further. Some people are saying that you are using the new products to your competitive advantage.

Are you saying that new products really are a defense mechanism because there has been a exodus of dollars to other financial institutions, and that you were forced to use the new product to protect your business?

Mr. **KIEFER**. The new products allow a different ability for companies to credit interest, which has been labeled excess interest over and above the assumptions that we have made actuarily.

We are going to take a fairly conservative stand on what we think interest rates are going to be over the next 30 years. However, I would point out that actuarily, assumptions have risen rapidly over the last 3 or 4 years as to what pressing assumptions you build in your products, so with the new products if, in fact, we can earn excess interest over and above the assumptions we have calculated, we have a chance to return some of those to the policyholder.

That does two things, obviously. It is going to increase benefits to the policyholder and it is also going to reduce profits to the insurance company, because if we do agree to return those excesses, we are not going to earn that excess premium as we have in the past.

Mrs. **KENNELLY**. Mr. Chairman, one last question. Yesterday I asked the spokesman for the mutuals if he thought this process that we began yesterday could be finished this session.

Do you think it is possible to carry out this charge within this session?

Mr. **LEBED**. We have submitted a proposal which would be a relatively simple thing to enact, and I think we would have to say the answer is yes. Most of our proposals involve making permanent certain provisions in TEFRA and three or four other changes.

Mrs. **KENNELLY**. The only problem is the other proposals are very similar.

Mr. **LEBED**. There is a way of doing it.

Chairman **STARK**. Mr. Duncan.

Mr. **DUNCAN**. I have no questions.

Chairman **STARK**. Mr. Flippo will inquire.

Mr. **FLIPPO**. Thank you, Mr. Chairman. I appreciate the testimony of the panel very much.

I would like to briefly inquire into one area for clarification purposes. That is the area pertaining to the one-half of underwriting again that the chairman was making inquiry about.

I understood your testimony to say that it has some purpose, a contingency purpose other than competitive balance, and I wonder if you would help me understand that a little better.

Are you talking about a stockholder surplus, or a policyholder surplus, and in fact has it ever served as a contingency fund in any of the operations that you are familiar with?

Mr. **Lebed**. Yes. Let me take a crack at that, Mr. Flippo. The deferred income, under the various provisions you are referring to, is going into a policyholder's surplus account, not a stockholder's surplus account, but it is combined with the shareholders surplus to form the overall corporate surplus. The overall corporate surplus is available as a pool to offset unexpected happenings and so forth, and in that sense there are frequent calls on surplus when companies lose money for various reasons.

As I pointed out to one of the chairman's questions, there is no mechanism to specifically withdraw money from the credited policyholder's account, so that the accounting of that would indicate that money isn't coming from the policyholder's surplus account when in fact it is.

Mr. **Flippo**. I guess it is very hard for me to understand exactly what you are saying. Are you saying that the fact that it is not taxed increases the profits, and the profit increases the shareholder's equity, and that from the shareholder's equity you may sometimes have to drawdown the surplus?

Is that what you are saying?

Mr. **Lebed**. That would be one way to look at it, yes.

Mr. **Flippo**. But generally there is no accounting provision dealing with the liability that might be associated with it. You mentioned that.

Mr. **Lebed**. There is not a direct accounting that says there was a dollar of unexpected loss that was applied against this particular account.

Mr. **Flippo**. If I understand you then, it is a fact that since it is not taxed, it increases the profit and goes into surplus and is therefore available for contingencies?

Mr. **Lebed**. Yes, that is a good way to look at it.

Mr. **Flippo**. We have had testimony suggesting that the provisions of existing law that permits reserves to be revalued for tax purposes may no longer be necessary. I wonder if you would care to comment on this subject.

Mr. **Turner**. Yes. I think there are three aspects that would probably need to be addressed. The first of these, I think, is a misconception that statutory reserves are overly conservative. As an actuary and as a president of a company, I can attest to the fact that not only are the risk assumptions by companies long term, but the severity of those risks today are just as great if not greater than those we have ever faced. Against that I would simply note that State laws establish only the minimum reserves. State law establishes only the minimum acceptable reserve for a limited purpose, leaving the judgment of the adequacy to a professional actuary who must attest to that effect in a statement submitted with each annual report.

The certifying actuary is primarily responsible then for assuring reserving to the extent necessary to achieve solvency, as well as to protect the long-term obligations outstanding to its policyholders.

Mr. **Flippo**. If I might interrupt, I wonder if the gentleman would make his point briefly, because I am running out of time, and I did have another point that I would like to make.

Mr. **Turner**. The point is that I think there is a misconception that statutory reserves are overly conservative. The next issue would be the use of net level reserves for tax purposes. I think the move, from net level to CRVM for statutury reporting purposes occurred after the 1959 act. The 1959 act, by allowing 818(c), neutralized the use of net level as a competitive advantage in the marketplace. Any move back away from 818(c) would reopen that issue.

Mr. **Flippo**. I see that my time has expired. I would have a few more questions I would like to submit in writing for the gentleman, and I do appreciate your testimony.

Mr. **Guarini**. Thank you. Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

I want to thank the panel for their testimony. It is very detailed.

As I undertand it, Mr. Lebed, you are saying that we can call it by any other name, but by the time we make the provisions for the smaller companies, by the time we make provisions for some passthrough on dividends for the mutuals and take care of all these other items, we are back to something very similar to the 1959 act?

Mr. **Lebed**. That is exactly what I am saying.

Mr. **Turner**. Our group did in fact examine alternatives, not only the 1959 act. I think there was a representation that we would look for alternatives, and quite frankly, having looked at all of the alternatives, our conclusion was that the concepts underlying the 1959 act were simple and still valid, and that any other alternative would end up being just as complicated, if not more so, by the time you built around all the ifs and buts.

Mr. **Jenkins**. Let me ask you this. I am trying to decipher some figures from the Joint Committee print. All of us have been concerned about this so-called level playing field and I wonder if you could enlighten me on a couple of things.

I am looking at the comparison tables showing tax liabilities and assets for stocks and mutual companies. Beginning in 1959, I see that the mutual share of the tax liability was 65 percent, and the stock share was 35 percent, and the mutual share of the assets was 73 percent, stock share 27 percent.

Now in 1981 the mutual share of the tax liability had dropped from 65 percent to 41.7 percent. The stock share of the tax liability had gone from 35 percent up to 58.3 percent. By the same token the assets had changed, the mutual share had dropped to 57.9 and the stock share had gone up from 27 percent to 42 percent.

As I understand your testimony of a few moments ago, you were estimating the allocation of the 1982 tax liability between the mutuals and the stocks to be roughly 50–50. Is that correct?

Mr. **Kiefer**. I would say so.

Mr. **Jenkins**. I did not ask this, but I am assuming that the mutuals would say that the reason that their share of the tax liability has decreased since 1959 is directly relevant to the increase in the share of assets by the stocks.

How do you read this difference that we see over a period of some 20 years?

Mr. **Lebed**. Let me make two comments and then perhaps Mr. Kiefer or Mr. Turner would like to comment. First of all, I would say the relationship between tax liability and assets was actually quite balanced until 1980, looking at the figures you refer to, and that beginning in 1980 and 1981 is when you had the extensive use of Modco which shifted that balance considerably. That would be point No. 1.

Point No. 2, I am not sure whether this is what you are getting at, Mr. Jenkins, but there has been the contention that the mutual companies have been losing market share.

What has really been happening is that big companies have been losing market share to smaller companies. We and other large stock companies have been losing market share, because for the last 25 years there really hasn't been any new mutual companies coming into the business. As more companies have come into the business, they have taken on market share. The smaller companies have been aggressive and have come up with new ideas, thereby gaining market share at the expense of big companies.

It is not a mutual/stock thing at all.

Mr. **Turner**. I think that has been reinforced by studies of the mutuals themselves which indicate that mutuals, large mutuals, have lost market share for 130 years continuously. Obviously tax cannot cause that kind of market share over such a long period of time. In fact, there is a barrier to entry. It is very difficult, if not impossible, to form a mutual company. All the new companies have been stocks. There has been a significant shift in market shares, but I don't think it is at all related to taxation.

Mr. **Jenkins**. You think it should be roughly 60–40, was that your testimony?

Mr. **Kiefer**. The industry had agreed on 60–40 target when stopgap was under consideration. I wonder if I might make one other point that I think needs to be made.

Yesterday, I believe the comment was made by one of the mutual representatives that in 1959 they received a 90-percent deductibility of dividends, and, of course, the 1959 act brought in the concept of free investment income—that is a limitation on the mutuals ability to dividend out their equity to shareholders.

I think the fact is that in 1959 the act worked exactly as it should have. Investment earnings were low. Most of their earnings came from underwriting, which they could dividend out, and they did in fact dividend out, they get a 90-percent deduction. As interest rates increased over the years, then we saw that shift occurring where the majority of their income was coming from investments as opposed to underwriting income, and while there might have been some flaws in the application of that dividend, it did in fact work exactly as it should have, and in 1979 or 1980, I believe, dividend income was 60 percent, underwriting income was 40 percent, so mutuals got a 60-percent deductibility, so the act did in fact work exactly as it was intended to do, so the 90 percent had nothing to do with anything in the marketplace. It was strictly a function between underwriting and investment income.

Mr. **Jenkins**. I have one more question but I will wait until my second round.

Chairman **Stark**. Mr. Moore will inquire.

Mr. **Moore**. Thank you.

Gentlemen, I would like to get as brief answers as I could so I can try and get all five points addressed by this group of stock companies.

They are the points raised by Secretary Chapoton yesterday.

Mr. Turner, I understood you to say that you had no problem or it would be the position of the stock companies that they are willing to take a look at establishing a statutory definition of life insurance.

Mr. **Turner**. Such a definition exists now for certain policies and we are most willing to work with Treasury and/or your staff in extending that definition or in reviewing any changes that would be considered.

Mr. **Kiefer**. I also think there is a committee within the ACLI that is working also on this problem that is supposed to represent both stocks and mutuals.

Mr. **Turner**. We have been working within that structure for some months.

Mr. **Moore**. I would suggest you all get that to us as fast as you can. We didn't have much luck with that committee giving us a bill, so maybe we can get a definition out of it.

The second question concerns Secretary Chapoton's proposal that we modify the loan and withdrawal rules affecting policyholders such as was done in TEFRA for annuity contracts.

What position do you have on that?

Mr. **Lebed**. As I said to Mrs. Kennelly, that was a new proposal to us that we saw for the first time yesterday. We really need more time to look at that but before we would want to make any specific response.

Mr. **Moore**. A third point is one I think I know the answer to. It is one that we have talked about somewhat, and it relates to treating a portion of the policyholder dividends of mutual companies as a return on equity, and thereby taxable.

Would you agree with that approach?

Mr. **Lebed**. Absolutely.

Mr. **Moore**. A second part of that which I asked yesterday, is in figuring out the total tax burden of stocks versus mutuals and trying to create a level playing field, do you think it is appropriate that we take into account the amount of taxes paid by shareholders on dividends received on their stock in stock companies?

Mr. **Kiefer**. Yes.

Mr. **Moore**. The next one relates to the reserve deduction under section 818(c)(2). Obviously this affects smaller stocks more egregiously than it would the larger stock companies.

Would you or could you comment on whether this deduction could be limited to small stock companies as opposed to doing away with it entirely?

Mr. **Turner**. I think our proposal was that we support tax reserve equality, the same treatment for all companies. To put the issue of small companies in perspective, I think it is important to keep in mind that the top 25 mutual companies in our business control the majority of industry assets.

If you took the first 50 companies and set them aside and looked at the remaining 1,900 plus companies, the assets of the top 3 companies in our business, all of which are mutuals, exceed the total assets of the remaining 1,900 companies.

I think when you see that kind of concentration of competitive or economic power in our business, you have got a lot of "small" companies.

Mr. Moore. Am I to assume by that you would not like to see it separated? It is either all stocks get it or nobody gets it?

Mr. Turner. We would support the same reserve treatment for all companies.

Mr. Moore. All stocks and mutuals?

Mr. Turner. Stocks and mutuals.

Mr. Moore. The second half is the one that I have saved for last. That is the one that I think is most important, the elimination of the third phase deferral for stock companies.

Mr. Lebed. In my opening comments, Mr. Moore, I made a passionate plea that either that not be done or that in some other way there be a balanced approach to the taxation of underwriting profits for mutuals and stock companies.

Those deferrals are necessary to maintain the balanced present approach to taxing mutual companies.

Mr. Moore. That is my point. I understand your limitation, and I fully agree with you. We are not talking about doing just that. We are talking about taking a balanced approach and seeing to it that perhaps the mutuals' way of computing taxes is also changed.

Am I understanding you to say that if we kept the tax burdens the same in the aggregate on the two types of companies, you would not object to elimination of this?

Mr. Lebed. I would only ask that there also be recognition of the difference between stocks and mutuals with regard to risks that are being taken. Under participating insurance with the higher premium there is less risk than stock companies take under their non-participating approach to the business, and that would need to be recognized somehow.

Mr. Moore. Thank you, Mr. Chairman. My time is up.

Mr. Guarini. Thank you, sir.

I understand that all but Mr. Jenkins talked about under the 1959 tax provisions, that there have been a shift in the marketplace. Everybody talks about level playing fields and the essence of what we are trying to do is to form an equitable competitive arrangement between the stock companies and the mutual insurance companies, something that is fair and just.

I can't help but be impressed by the fact that both assets and the face amount of insurance have dramatically increased in favor of the stock companies from 1959 to the present time.

I know you said that they are more aggressive, and perhaps they have new creative types of insurance products that they are selling, but it seems to me that there has to be some truth that the tax structure and tax laws permit the stock companies to develop new products or cause them to develop new and different kinds of products.

You have got the same principles that exist in both companies. You have got the same amount of aggressiveness, I believe, but can you explain why there are new products and creative products in stock companies now, and we don't have that same thing existing in the mutuals, and that there has been such a tremendous curve in favor of the stock companies since the 1959 law?

Mr. LEBED. Let me make two comments, Mr. Guarini, and see if it is responsive. One, I must repeat that I believe the shift in market shares that has taken place reflects large versus small companies, not stocks versus mutuals.

Mr. GUARINI. What?

Mr. LEBED. The large stock companies have lost share just as much as the large mutuals have.

Mr. GUARINI. Then do you take the position that we should give small companies reevaluation of the deferrals and give them the advantage that we gave them under stopgap?

Mr. LEBED. I think that has helped small companies. I think that has been very good for the business and very good for the public.

Mr. GUARINI. If they already are doing very, very well, why should we give them advantages which we presently give them under the law, and is it your position that we should give stock companies that are smaller advantages over the large stock companies, or we should wipe out that differential?

Mr. KIEFER. I think to clarify this a little bit, the workings in the marketplace today may be such that what you find are many stock companies today who in effect broker business throughout the marketplace, and actually write through other distribution systems. You have product companies today and you also have distribution companies, and some of these product companies are able to trade off of other companies' distribution systems, so actually the marketplace is opening up, so that you have got some free enterprise going on between producers.

Mr. GUARINI. Should we give stock companies that are smaller advantages in our tax law?

Mr. KIEFER. When we define small stock companies, there are certainly many small stocks and mutuals out there today. You find certain streakers in the business today. If you look at your rankings on the new amount of issued and placed, you will find certain companies streaking today in terms of the writings they are making.

Mr. GUARINI. Are these the ones also having no tax liabilities?

Mr. KIEFER. I don't know that because I haven't looked at them. But I don't think they would qualify in many cases for the small stock company deduction. They are not small anymore. They are growing rapidly, most very rapidly.

Mr. GUARINI. Define for me a small stock company in the terminology of your industry.

Mr. TURNER. Almost any of them other than the top three. In fact, you can even include those if you would like to compare them against large mutuals. I would like to respond to the issue of being able to compete in the marketplace.

The statement made yesterday about the mutuals being able to deduct 90 percent of the dividends in 1959, the stocks weren't put out of business, and everything has gone great.

I can tell you if you talk to any of the field people in a stock company they will tell you they have consistently and continuously struggled to stay in the marketplace. We could not compete with the mutuals in the 1960's and 1970's in terms of permanent life insurance .

Mr. GUARINI. How much money did you pay in tax liability last year?

Mr. TURNER. Last year we didn't pay any tax; however, for the 5 years ending in 1981, we had over a 30-percent average tax rate.

Mr. GUARINI. In 1982 you paid no tax?

Mr. TURNER. We paid no tax in 1982.

Mr. GUARINI. Mr. Lebed, in 1982 how much tax did you pay?

Mr. LEBED. About $80 million.

Mr. GUARINI. And what are your gross assets?

Mr. LEBED. Our gross assets? Around $15 or $16 billion.

Mr. GUARINI. Mr. Kiefer, what tax did you pay, sir?

Mr. KIEFER. Estimated on nonexempt before Federal tax last year of $3 million, over the last 5 years, however, we paid—and this is the question that was raised, I believe, by Congressman Dorgan, on whether we are using the same base, but we paid an effective rate of 45 percent on nonexempt income over the last 5 years.

Mr. GUARINI. But last year you paid $3 million?

Mr. KIEFER. $3 million.

Mr. GUARINI. How much gross assets do you have?

Mr. KIEFER. 737.

Mr. GUARINI. 737?

Mr. KIEFER. Million.

Mr. GUARINI. Million?

Mr. KIEFER. Million.

Mr. GUARINI. Million dollars?

Mr. KIEFER. I am sorry, premium. Gross assets about $1.5 billion.

Mr. GUARINI. Billion dollars?

Mr. KIEFER. Right.

Mr. GUARINI. You paid $3 million?

Mr. KIEFER. That's correct.

Mr. GUARINI. You were able to invest $1.5 billion?

Mr. KIEFER. That's correct.

Mr. GUARINI. Could I ask you gentlemen what I asked the mutual companies, if you would be good enough to provide for the last 3 years the annual statements that you filed so that we can compare them with the mutual companies, and the statements you filed with SEC, which is the GAAP statement, I understand, and let us know what your last 3 years tax liabilities are that you paid the Federal Government, so we can get a comparison which would be a fair comparison. We would like to see how the balance sheets of your companies stack up against the balance sheets of mutual companies.

Mr. LEBED. We would be happy to. We have provided a lot of data to the Joint Committee, the staff of the joint committee.

Mr. GUARINI. I don't want to be inundated with data except I would like your annual reports, the statements you filed with the SEC, GAAP, and how much in taxes you have paid in the last year.

Mr. LEBED. We would be happy to provide that.

Mr. GUARINI. If you haven't done your 1982 return give us your estimates because I understand you can get extensions and you may not have figured it out yet, because while we are deliberating we would like to have the advantage of being able to compare the companies. Thank you.

[The following was subsequently received:]

[Materials referred to in the following letter have been retained in the subcommittee files.]

LIFE OF VIRGINIA,
Richmond, Va., May 27, 1983.

Hon. FORTNEY H. STARK, Jr.,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN STARK: Enclosed with this letter are the financial reports for life of Virginia which were requested during the recent hearings of the Subcommittee on Select Revenue Measures into life insurance taxation. These reports are as follows:

(1) Annual reports filed with the state insurance departments (Convention Blanks) for 1980, 1981, and 1982.

(2) Annual reports to Shareowners for 1981 and 1982 (note that the 1981 Report displays the relevant data for 1979 and 1980).

The following notes may assist you in understanding the enclosed material:

(1) We have provided a summary sheet showing the pertinent statutory and GAAP information. This summary also shows statutory data for years back to 1974 in order to provide a clearer idea of the general level of taxes paid by Life of Virginia than is provided by the most recent three years.

(2) You will note a marked decline in our taxes incurred since 1978, from $14.9 million to a negative $6.8 million. An analysis of this change of $21.7 million will give you an insight into the reasons for the decline.

(*a*) $12.2 million arises from increased investment in tax-favored investments of the type generally available to all corporate taxpayers; these include deep discount bonds, tax-exempt investments, common and preferred stock, "safe harbor" leases, and leveraged purchase/leaseback arrangements.

(*b*) $7.6 million arises from rapid sales growth, mostly universal life, together with the attendant expense increases for such things as advertising, data processing systems and development of brokerage outlets. Our individual life sales over the four-year period increased at an annual rate of 24 percent in face amount (with a 40 percent growth in 1982 alone), compared to an annual growth rate of 8 percent over the previous five-year period (1974 to 1978).

(*c*) $1.3 million from various other sources, including increased availability of "special deductions" under the TEFRA safety net and the change in the corporate tax rate from 48 percent to 46 percent.

In addition, we would call to your attention certain qualifications to keep in mind in interpreting the data you will receive from us and from others.

(1) The statutory statement (Convention Blank) shows three main federal income tax entries not relating to capital gains:

(*a*) Taxes incurred (page 4, line 30): this shows taxes paid with respect to the year in question, based on the Company's estimates. Because returns are actually filed after the Blank is prepared, there may be some estimates involved. Further, it is the usual practice to include in this item a provision for additional taxes payable upon conclusion of the revenue agent's audit of the year in question. This latter item is, of course, a highly conjectural amount.

(*b*) Taxes paid (Exhibit 12, line 28.2): this number is probably of limited value for your purposes since it may be a mixture of many years' taxes: current payments on current year's taxes, payment on extensions for last year's taxes, and settlement amounts (payments or refunds) on any number of prior years' filings.

(*c*) Increases in taxes due or accrued (page 4A, line 8): this is the difference between taxes incurred (page 4, line 30) and taxes paid (Exhibit 12, line 28.2) excluding the capital gains portion.

(*d*) Tax-related information may also be found elsewhere in the Convention Blank for some companies in some years. In particular, during the "820 Mod Co years" the methods used to provide reserves for possible adverse treatment of Mod Co tax savings, and the subsequent release of those reserves after the passage of TEFRA, were reflected differently by different companies. They may have been included in the usual tax figures, or may have appeared on separate write-in-lines, either in gain from operations or in adjustments directly to surplus.

(2) Our Annual Reports cover the entire Continental Group; however, the Financial Sections display figures for insurance operations separately, and further break out some items for the life insurance segment separately. Life of Virginia is included in the life insurance segment, and in fact constitutes all or nearly all of that segment.

I trust that this information will be sufficient for your purposes. If we can be of any further assistance in your studies, please let me know.

Sincerely yours,

John J. Palmer,
Senior Vice President.

Enclosures.

SUMMARY OF FEDERAL INCOME TAX AND RELATED DATA FOR LIFE OF VIRGINIA—1974 THROUGH 1982

[In millions of dollars]

	1982	1981	1980	1979	1978	1977	1976	1975	1974
1. Statutory gain before tax (CB, p. 4, 1. 29)	35.9	35.8	42.6	40.6	35.3	33.1	31.8	30.1	29.8
2. Statutory tax incurred on operations (CB, p. 4, 1. 30)	(6.8)	(1.1)	8.1	10.4	14.9	13.3	12.0	10.7	10.0
3. Statutory tax paid (CB, Exh. 12, 1. 28.2)	(3.8)	6.6	8.5	12.5	16.5	10.1	13.0	10.9	10.7
a. Capital gains tax included above	.5	1.6	(1.1)	.7	3.3	0	.9	0	.5
4. GAAP gain before tax:									
a. Life insurance segment	49.7	52.6	51.7	54.2					
b. Life of Virginia portion of above [1]	49.7	52.6	50.5	52.6					

[1] Not shown separately in annual reports.

Mr. **Lebed**. Mr. Chairman, is it OK to volunteer one comment?

Chairman **Stark**. Certainly, by all means.

Mr. **Lebed**. A lot of questions have been asked that relate to company assets, and I would just like to make the point that assets of the industry and individual companies can be very greatly distorted by pension business. Most of the taxes come from life insurance business, and I think that is an important distinction.

Chairman **Stark**. I appreciate that. However, I think the figures that come out if you look at any company, mutual, or large stock is generally under 1 percent of assets, and I don't know what that means. I suspect, although we don't know, that there are an awful lot of small stock companies that zero out fairly regularly or pay very little in tax. Again I make no judgment on that in that there may be a lot of extenuating circumstances that make you lose money, but on this level playing field we are talking about, questions have come up often on how small is small.

There is no politician here on Capitol Hill that wouldn't wave the flag for small business. The only question is does that get up to be Chrysler size or does that just get down to be the local auto dealer on the corner? It is a definitional problem.

I want to come back to several comments that you have all made.

It is very difficult for me to accept that there is any major difference in some of the excess interest type of products and the dividend to a policyholder in a mutual company.

Do you care to comment on that?

Mr. **Turner**. We have proposed 100 percent deductibility of all amounts paid to customers as customers, both for stocks and mutuals, and I think this is recognized by Treasury.

Chairman **Stark**. That quantifies my answer.

Mr. **Turner**. The differentiation is only relevant if there is a different treatment.

Mr. **Lebed**. Could I take a crack at that?

Chairman **Stark**. Then let me go on and add that in your testimony the current disallowance for any dividends of 22½ percent I think is referred to as, I am not sure exactly, unduly generous, but I think that is the inference.

Do you want to comment on both of those?

Mr. **Lebed**. To get at your first question, Mr. Stark, I think the fundamental fact to keep in mind is that after whatever treatment we give the customer in terms of excess interest in whatever new policy and so forth, we still make payments to shareholders, which are not deductible, and those shareholders pay tax on those dividends. That is purely and simply the difference between us and mutual companies. They are paying it all in one fell swoop to the policyholder, and the combination is quite different.

Would you remind me what your second question was? Oh, the 22½ percent.

Chairman **Stark**. Yes.

Mr. **Lebed**. Yes. What I was saying is that the 1959 act provide——

Chairman **Stark**. What do you think it should be?

Mr. **Lebed**. I don't know if you were here when I got to the point, Mr. Chairman, but I said that every way we have looked at it, it appears to us that under current economic conditions, and that is an important qualifier, that the maximum allowable deduction for dividends to mutual company policyholders should be 60 percent, or compared to the 22½ percent, 40 percent disallowed.

Mr. **Turner**. I would like to add that that reflects the application of the limitations in the 1959 act, that is, limitations which reflect the concept called "free investment income." To amplify on it, that concept was developed in about 1916 or 1920, and was, in fact, developed by and sponsored by mutuals. I think the record will so indicate, that it is the only true basis on which to tax a mutual company. The 1959 act is nothing more than a limitation on the ability to deduct dividends and zero-out gains from operations.

Mr. **Lebed**. One of the ways we looked at it, Mr. Stark, was to take dividends that stock companies pay to their shareholders and say what percentage of stockholder equity is that for stock companies.

Chairman **Stark**. How did you determine that? We were trying to determine that yesterday.

Mr. **Lebed**. I would have to refer to the technicians on the details, but that, conceptually, is what we did. We then tried to impute a stockholder's equity to the mutual company, and said what would that produce.

Chairman **Stark**. Secretary Chapoton referred to that yesterday in his testimony, and, as I say, any suggestions are encouraged, although I tend to dislike encouraging one segment of the industry to stick it to the other segment, so to speak, but that seems to be one of the ways we get our ideas.

Mr. **Turner**. You might call it motivational.

Chairman **Stark**. I might as well invite your comments. One question that the committee talked about yesterday was what would be a procedure? We can all argue about the numbers as we have said right off, but what would be the procedure for estimating what share of the policyholder dividend or the assets of the mutual company relates to the share of your stockholder's surplus? We are not questioning the legal definition of ownership, but are searching for a procedure to use as a balancing mechanism? If you have any ideas——

Mr. **Lebed**. All I can say is that some stock companies have attempted to take a look at that, and I would be happy to see if I could share that.

Chairman **Stark**. Do you take a percentage of assets? Is there a standard throughout the industry where stock companies have stockowner's equity relative to insurance in force, relative to investment assets? I am just looking, and I am sure the rest of the committee is, for some things that make some sense and can be judged empirically rather than just philosophically.

There is one other series of questions that I would like your response to and then I think other members may have some questions. Let me get through these because it covers several areas that have come up. I would like you to comment on the justification for the special deduction on group insurance, since it has been suggested that your companies are really able to very accurately determine risk, particularly underwriting risk, that we have heard no evidence of anybody really needing special protection.

Second, how do group life, accident, and health insurance differ? Is there a greater financial risk in accident and health? I rather suspect there is. Would you comment on Professor Nielson's testimony where she talked about a special contingency reserve based on individual product lines? I don't know what I think about that, but those are areas that I would like your comments on.

Mr. **Lebed**. I will take a crack at it. Our company is very active in that business. I would emphasize the point that the special deduction for group does apply to group life, accident, and health, and as far as the risk part of that, I would say that the accident and health part is the more risky part. The part of the accident and health risk is, for example, long-term disability risk, which is one of the riskiest lines of insurance around.

Chairman **Stark**. Has that become more risky in recent years with more reasonable definitions of disability?

Mr. **Lebed**. Yes, and higher for many reasons. So there are very considerable risks there. That was part of what I think was being recognized by the special deduction. As far as Professor Nielson's testimony, I personally am not familiar with it.

Chairman **Stark**. I will try that another time.

Do other members of the committee want to get in for a second round here? Mrs. Kennelly.

Mrs. **Kennelly**. Yesterday, Treasury expressed some concern about consolidation of returns. I asked ACLI if they had seen any sign that bottom-line consolidation had been used in an abusive fashion. They said no. I know, sir, that you have a section of your testimony on consolidation, but this is an important item to me, I wonder if you could just expand a little bit on the use of this method of taxing corporate profits.

Mr. **Lebed**. Yes. We are in favor of, and our proposal includes, bottom-line consolidation as opposed to phase-by-phase consolidation. First of all, this would put us on an equal footing with other businesses, I think, in terms of consolidation rules. The phase-by-phase consolidation, we think, really defeats the purpose of the intent of the 1959 act.

You could have subsidiaries, in fact, we have a case in point in my own company, of a subsidiary losing a lot of money. If you had to consolidate on a phase-by-phase basis would have to pay high taxes at the same time that large amounts of money are being lost. We think the results are not appropriate.

If you would inquire further, I would be happy to try to respond.

Mrs. **Kennelly**. Could you just expand a little bit more on the concept for me?

Mr. **Lebed**. You mean what bottom-line consolidation is?

Mrs. **Kennelly**. I think I know, but expand on the importance of it.

Mr. **Lebed**. It gets relatively technical but the basic idea is to determine the tax for each separate company separately, and then consolidate them on the basis of bottom-line results as opposed to combining the various pieces of the tax computation and getting one single result.

As I say, just to mention an example, we have a company that lost a lot of money that if it was on a phase-by-phase consolidated basis would have paid $15 million in taxes against a $21 million surplus, and at a time when it was losing money. That would have been the effect of the phase-by-phase consolidation proposed by the Treasury Department.

Mrs. **Kennelly**. I think what Mr. Chapoton was afraid of is that bottom-line consolidation might be used in an extreme form for tax planning.

Mr. **Lebed**. You mean for manipulation purposes and so forth?

Mrs. **Kennelly**. Yes.

Mr. **Lebed**. We really don't believe there is a tremendous amount of opportunity for that.

Mr. **Turner**. I think the only source of abuse that has emerged with respect to phases is obviously through a reinsurance mechanism, and the only incidence of that that I am aware of in my involvement in the business has been section 820. I think our response is, if it leads to abuses, that those abuses be identified and responded to very quickly, such as section 820 was. I am not aware of any abuse or potential abuse attributable to a matter of tax principle.

Mrs. **Kennelly**. Until it was brought up yesterday, I didn't have any concerns either. I would think with the stocks bottom-line consolidation was a fair way of doing your tax computation. Maybe the importance of it is more important in my mind than in your mind.

Mr. **Lebed**. No, no, we think it is very important. That is an important part of our proposal, and we thoroughly agree with you that that is a fair way to do it. If I give you any other impression, I didn't mean to.

Mrs. **Kennelly**. Thank you, sir.

Mr. **Turner**. I would amplify Mr. Lebed's response to add that we very strongly believe that a stock subsidiary of a mutual company should be taxed as a mutual.

Mrs. **Kennelly**. Would you say that again?

Mr. **Turner**. A stock subsidiary of a mutual company should be taxed as a mutual. You should look to the ultimate nature of ownership. Otherwise you are leaving open a major loophole for tax avoidance or for significant loss in tax revenue.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Jenkins.

Mr. **Jenkins**. I am very much interested in the proposal that the mutuals put on the table yesterday.

But I am always somewhat wary of the part that a segment of an industry is willing to give up, and that is what I want to talk about just a moment now. As I understand, the mutuals testified basically that they were willing to give up the reserve provisions and maybe the 818(c)(2) but with some adjustments to take care of the smaller companies, and they were not overly concerned about the 50-percent deferral from operating profits. Now, how important are those two items to the mutuals?

Mr. **Turner**. I would respond to say that they are rather dramatic. I think you are heading in the right direction in terms of your observations. The mutuals simply, and very simply, want to give up things like 818(c); they want to go to CRVM reserves in order to get full deductibility of dividends.

Mr. **Jenkins**. I understand.

Mr. **Turner**. I will note, however, in their elimination of 818(c) that they did impute a cash value minimum test. They said go to a preliminary term reserve method subject to the reserve not being less than the cash value. This opens up the possibility for almost the same things we saw back in 1959 against, or acting to the detriment of, small companies because a mutual obviously could grade their cash values into the net level reserve, therefore in essence establish net level reserves. A small company would not have the surplus to do so. Succinctly stated, the mutuals want to give up 818(c), or net level reserve method, to get full deductibility of dividends, and in return for that they are asking the stocks to give up fundamentally two things: One is the same, 818(c), or the net level deduction; and the second is deferral. So they give up 818(c) and get full deductibility of dividends. We give up 818(c) and deferral, and get nothing.

Mr. **Jenkins**. They do not use deferral themselves; is that right?

Mr. **Lebed**. No, no, they get full deduction of their underwriting profits and the stock companies get deferrals.

Mr. **Jenkins**. So if we eliminate that aspect of the existing law entirely, they give up nothing. Is that what you are saying?

Mr. **Lebed**. That is right.

Mr. **Jenkins**. Is that right?

Mr. **Lebed**. That is exactly right.

Mr. **Jenkins**. And they don't give up anything if we get rid of section 818?

Mr. **Turner**. We both give that up. They give it up and that is the only way they can get 100 percent deductibility of dividends, which is what they seek.

Mr. **Jenkins**. Then your testimony is that in their proposal they have not given up anything.

You don't think it is a good trade?

Mr. **Lebed**. I think it is a good trade for mutual companies.

Mr. **Turner**. They trade and come out even and we come out losers.

I have to comment that there are several implications that have been made with regard to my company's taxes. I will simply note we did, in fact, pay no tax in 1982; however, over the last 5 or 6 years we have, in fact, paid an effective tax rate on statutory gain from operations in excess of 30 percent. We didn't pay any taxes in 1982 because we have enjoyed a very dramatic growth rate in our business, and I think we are experiencing the same kind of increases in cost and reductions in tax as you would see in any other rapidly growing businesses.

Chairman **Stark**. You are here to thank us for the generous tax subsidy.

Mr. **Turner**. In addition, our tax liability was greatly reduced by certain investments with favorable tax characteristics generally available to all corporate taxpayers.

Chairman **Stark**. I want to thank all of you. I hope that you all continue to confer with us as we go through the process of writing a bill. Your input is important and we appreciate your taking the time to help us through this complicated procedure.

Mr. **Lebed**. We thank you, and we will cooperate in any way we can.

Chairman **Stark**. Our next panel is a small company trade association panel. It is the National Association of Life Companies, represented by W. Ashley Verlander, president of the American Heritage Life Insurance Co., of Jacksonville, Fla., accompanied by Roy Woodall, executive vice president of the NALC; Life Insurers Conference, represented by Robert S. Greer, president and chief executive officer, and F. C. McMains, Jr., vice president and general counsel of the Union National Life Insurance Co., at Baton Rouge, La.; National Insurance Association, represented by George E. Hill, president and chief executive officer of Winston Mutual Life Insurance Co., of Winston-Salem, N.C.; and Charles A. Davis, executive director of the National Insurance Association.

Gentlemen, welcome to the committee. We have been provided with copies of your testimony, which we thank you for, and which will appear in the record in their entirety.

I would ask each of you to summarize your testimony and make any additional comments you wish. I know most of the members have questions that they have prepared after having read your testimony, and I think we will get a more extensive and useful record if we can enlarge upon your prepared testimony in that manner.

I will call on Mr. Verlander as the first witness listed.

You may proceed in any fashion.

STATEMENT OF W. ASHLEY VERLANDER, PRESIDENT, AMERICAN HERITAGE LIFE INSURANCE CO., JACKSONVILLE, FLA., REPRESENTING NATIONAL ASSOCIATION OF LIFE COMPANIES, ACCOMPANIED BY ROY WOODALL, EXECUTIVE VICE PRESIDENT

Mr. **Verlander**. Thank you very much, Mr. Chairman.

Mr. Chairman and members of the subcommittee, my name is Ashley Verlander. I am president of the American Heritage Life Insurance Co., of Jacksonville, Fla., and I am appearing here today on behalf of the National Association of Life Companies.

This summer I will be assuming the position of president of the NALC. With me today is my colleague and friend, Mr. Roy Woodall, executive vice president of the NALC.

The National Association of Life Companies was organized in 1955, and today has over 300 member companies. We are headquartered in Atlanta, Ga. These companies are primarily small- and medium-sized stockholder-owned, life and health insurance companies, and I would like to request, Mr. Chairman, if I may, that my full statement and a list of our member companies be printed in the record.

Chairman **Stark**. Without objection, Mr. Verlander.

Mr. **Verlander**. Thank you, sir.

Mr. Chairman, we welcome the opportunity to appear here today to address the issues before this subcommittee, from the perspective of the smaller life insurance companies. We of the NALC appreciate the fact that Congress always has been attentive to the special problems and special needs of small businesses, and that includes the small life insurers of this Nation.

There are particular problems and difficulties associated with the operation of a small life insurance company that may not be comparable to other industries because our business is completely dominated by a relative handful of giant enterprises.

We small companies are more sensitive to adverse claims experience than the larger companies, even though the mortality tables provide a basis for all of us.

We cannot stand the shocks to the mortality tables that the giant companies can stand.

Also, from an income standpoint, we do not have the wide field of investment opportunities that they do. There is probably not one company in our entire association that could make a $25 to $30 million single private placement investment no matter how great it might look. That would be more than the net worth of most of our companies, and in many cases more than the total assets of our companies.

Advantages other than these, Mr. Chairman, accrue to economies of scale throughout the entire life insurance operation.

We would like to echo the sentiment of those who have testifed before us, in stating our strong opposition to any change in the historic tax treatment of the inside buildup on life insurance contracts.

Having said this, we would like to focus on the corporate tax issue before this subcommittee, and in particular, I would like to emphasize a few points that are very important to small companies.

No. 1, we strongly support the approach in the 1959 act on the limitation of deductibility of dividends by mutual companies. If the giant mutual companies are not limited in the deductibility of their dividends, it will be extremely difficult for us smaller companies to compete on an equitable basis with them.

No. 2, the 1959 act permits companies to revalue their preliminary term reserves to a net level basis under section 818(c). Absent the preliminary term basis and revaluing on an approximation basis, small companies' growth would be severely limited.

We would have to fund from current premiums and small existing surpluses the policy acquisition costs, the full reserves, and any Federal income taxes resulting from there. This would create such a strain on our surplus that production would have to be limited very early each year.

Without the equalization that section 818(c) provides, small life insurance companies will suffer a severe competitive disadvantage solely as a result of the operation of the tax law.

Our third point relates to a provision added on a temporary basis to the 1959 act last year in TEFRA. Congress recognized, in enacting this, that the $250,000 so-called statutory amount in section 809(f) should be increased to $1 million due to inflation.

We strongly urge that the TEFRA provision be made permanent.

No. 4, and finally, the 1959 act also allowed a small business deduction up to a maximum of $25,000. We would recommend this deduction be increased to $100,000, but that it be targeted for the first time to small companies only.

In conclusion, Mr. Chairman, we of the NALC are appreciative of the opportunity to testify before you today, and if you have any questions of us, we will attempt to do our best to respond to them.

[The prepared statement follows:]

STATEMENT OF W. ASHLEY VERLANDER ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures: My name is W. Ashley Verlander. I am president of the American Heritage Life Insurance Company of Jacksonville, Florida, and I am appearing here today on behalf of my company and the trade association of which it is a member, the National Association of Life Companies ("NALC"). This summer I will be assuming the position of president of the NALC. With me today is my colleague and friend, Mr. Roy Woodall, the Executive Vice President of the NALC.

The National Association of Life Companies was organized in 1955 and today has over 300 member companies domiciled in 42 states. NALC companies are primarily small- and medium-sized, stockholder-owned life and health insurance companies. These companies account for more than 200,000 home office and field employees and an estimated 60 million policyholders. The offices of our organization are located in Atlanta, Georgia. We ask that the attached list of NALC member companies be printed in the record at the conclusion of our statement.

Mr. Chairman, we welcome the opportunity to appear here today to address the issues before this Subcommittee from the perspective of the smaller life insurance companies. We are pleased to participate in these hearings with our sister trade associations representing small companies, the Life Insurers Conference and the National Insurance Association. We of the NALC appreciate the fact, as the members of this Subcommittee are aware, that Congress has always been attentive to the special problems and needs of small businesses, including the smaller life insurers of this Nation. There are, of course, particular difficulties and entrepreneural risks uniquely associated with the operation of a small insurance business, especially in view of our business's domination by a relative handful of giant enterprises. A small- to medium-sized life insurance company is, simply by virtue of its size, more sensitive to financial fluctuation arising from adverse claims experience than are its larger brethren. Also, a small company frequently does not have the investment opportunities, the ability to attract experienced personnel, the wherewithal to sustain large home office staffs, and, in general, the advantages accruing to economies of scale, as is the case with a larger company.

For these reasons, and for other reasons which I could list, Congress has been solicitous of the needs of smaller businesses, and we think properly so, in writing our Federal income tax laws. The tax law is, of course, the focus of our concern today. We might also mention, in this connection, the historic congressional awareness of the advisability of drafting our tax laws in a manner that is attentive to the special needs of small businesses, and even in a manner that favors small businesses, quite apart from concerns with proper income measurement for tax purposes. We refer here, of course, to the pursuit of national policy in promotion of competition. Congress has repeatedly recognized that provisions in our tax laws which permit small businesses to be established and to survive, and, better yet, which help them to thrive, are in the Nation's best interest. Certainly, we encourage this development.

Focusing on the tax issues specifically before this Subcommittee, we of the NALC wish to state our unqualified agreement with the testimony delivered by representatives of the Stock Company Information Group ("SIG"). Furthermore, we endorse the proposal placed before this Subcommittee by those representatives, and we commend it to your consideration. Also, we wish to express our strong agreement with the testimony delivered by representatives of the National Association of Life Underwriters.

Both those statements strongly opposed any change in the now 70-year-old tax treatment of life insurance death benefits and of earnings credited to reserves for life insurance and annuity contracts. NALC companies firmly agree that there should be no change in this historic treatment of the so-called inside build-up of life insurance policies and annuities. Any such change would run counter to sound social policy and sound tax policy, and it would be disastrous for insurance consumers and beneficiaries. Taxing the inside build-up would serve to discriminate against cash value life insurance in favor of term insurance, even though the former is merely a levellized, controlled-cost version of the latter. Such discrimination makes no sense and, as the SIG statement clearly shows, it would operate only to reshuffle savings in an arbitrary fashion while also increasing the tax burden on low- to middle-income Americans. Indeed, in view of the wide-spread holding of insurance policies by the American public, any tax, direct or indirect, now levied (for the first time) on the inside build-up would amount to a general tax increase—and a tax increase aimed directly at savings intended to protect against financial losses due to premature death.

Accordingly, the NALC flatly rejects any proposal to place a tax on the inside build-up of life insurance policies and annuities, to the detriment of the vast majority of Americans who are the holders and beneficiaries of these contracts. Further, on the positive side, the NALC, as we just indicated, lends its strong support to the view that the Life Insurance Company Income Tax Act of 1959 should be retained as the basis for taxing life insurance companies. We commend to this Subcommittee's consideration the following aspects of the 1959 Act, and of the SIG proposal to modify the Act, which are of great importance to NALC member companies:

1. DIFFERENCES BETWEEN MUTUAL AND STOCK COMPANIES

The 1959 Act properly takes into account, for tax purposes, the operating differences between mutual and stock companies, including the more than 300 stock companies that are members of the NALC. Unless mutual life insurance company dividends to policyholders are limited in deductability as the 1959 Act provides, the return on equity passed along to mutual life company owners (their policyholders) will be deductible at the corporate level, contrary to general tax principles, and the giant mutual life companies of our Nation will pay little or no tax, contrary to tax fairness and equity. Mutual life company dividend distributions must not be fully deductible, in recognition of their nature as partly a distribution of corporate earnings to owners, or otherwise stock life insurance companies will be competitively disadvantaged solely by operation of the tax law. Stock life insurance companies must, of course, pay a corporate tax on the net earnings that they retain for their use or that they pay out to their shareholders. No one has suggested that this should change; our comment is, simply, that the same rule should apply to the vast corporate enterprises known as mutual life insurance companies.

2. CORPORATE TAXATION OF STOCK COMPANY DISTRIBUTIONS AND DEFERRALS

The 1959 Act made benefit payments fully deductible by stock companies, except that dividend distributions, along with certain deferral items, were made subject to the dividend fashioned for mutual life companies. NALC companies agree with the SIG view, and endorse the SIG proposal to the effect, that the impositon of this limitation on stock companies was erroneous from the start and should now be removed. All stock company payments or credits to their policyholders/customers, whether as death benefits, surrender proceeds, dividends, excess interest credits or otherwise, should be fully deductible as part of the cost of doing business. These items, having been given away by the company, are not part of its taxable profit base.

3. DEDUCTIBILITY OF UNDERWRITING LOSSES

Under ther 1959 Act, so-called "underwriting losses," which many of our members generate, are made fully deductible in determining corporate taxable income. This aspect of the 1959 Act cured what was, in our view, a major defect of the investment-income-based taxing statutes that had been in effect prior to the enactment of the 1959 law. This is a matter of particular concern to small companies, and we would oppose, very strongly, any change in this regard. As the report of the Ways and Means Committee on the 1959 Act observed (H.R. Rep. No. 34, 86th Cong., 1st Sess. 3-4 (1959)):

"The most basic problem involved in the taxation of insurance companies arises from the fact that any formula based only on investment income omits from the tax base significant elements of income and loss. This omitted segment for convenience may be called "underwriting" income or loss. Under the bill [the 1959 Act], this underwriting income (or loss) is measured as the difference between the gain or loss from total operations of the company and the taxable poriton of its investment income. By and large, it arises from premium charges which are in excess of the charges required to meet that part of the claims of policyholders and their beneficiaries which are not met by interest additions to reserves. Another element of underwriting income or loss may arise from the amount included in the premium to cover expenses of the policy being either larger or smaller than the actual expenses incurred during the life of a policy.

"* * * It also has developed that many insurance companies have shown a loss on their total operations and have still been subject to a Federal income tax on the basis of a [pre-1959] formula which looked only at their income activity and not at their total activity.

* * * * * * *

"Taking underwriting gains or losses into account does not necessarily mean a larger tax base. Many *small, new and growing* life insurance companies have underwriting losses rather than gains because of the additional initial costs they incur (such as agent's commissions) in placing the new policies on their books. In such cases, under your committee's bill, these underwriting losses offset investment income otherwise subject to tax." [Emphasis added.]

On the same point, the Senate Finance Committee report, in discussing "special features for small and new businesses," had this to say about the deductability of underwiting losses (S. Rep. No. 291, 86th Cong., 1st Sess. 9 (1959)):

"Where there is a loss from underwriting operations, both the bill as passed by the House and as amended by your committee provide that this loss (but with certain limitations as to the deduction of policyholder dividends, the special deduction for nonparticipating policies, and the 2-percent deduction for group insurance) may be offset in full against the investment income tax base even though, if there were a gain from the underwriting operations, only half of this would be taxed currently. This is likely to be *more beneficial to small and new businesses* than to their well-established competitors because such companies generally are incurring large expenses (such as agents' commissions) in attempting to expand the business on their books. [Emphasis added.]

4. DEFERRAL ITEMS

The 1959 Act provides life insurance companies with specified deferrals for nonparticipating contracts and for accident and health and group insurance contracts. These deferrals were intended to be of primary benefit to stock life insurance companies and, we think, they are of great importance to the smaller companies. The SIG testimony has explained the reasons for these deferrals, why they should be continued, and why the 1959 Act's limitation on their availability should be removed. Suffice it to say that we agree with that testimony. We simply wish to underscore the significance of these deferral items for small companies.

5. REVALUATION OF PRELIMINARY TERM RESERVES

NALC member companies compute their life insurance reserves on what is known as a "preliminary term" basis. This means that in computing minimum reserves for State law purposes our companies are, in effect, given credit for large first-year expenses that they must bear to put new policies "on the books." Without being given such a credit, our companies could not grow very fast as compared with larger, surplus-rich companies, for we would have to fund from current premiums and from our existing surplus both the policy acquisition costs and the full reserves, a situation which would unduly strain our surplus. When it comes to tax computations, however, preliminary term reserves tend to produce a discrimination against smaller companies as contrasted with the higher reserves (know as "net level" reserves) held by the larger companies, unless the tax law provides some device for equalizing the tax effect of these two reserving systems.

The 1959 Act did this, in a provision codified as section 818(c) of the Internal Revenue Code, by allowing companies that hold reserves on a preliminary term basis to adjust those reserves to a net level basis for tax computation purposes. As the Ways and Means Committee report explained in 1959 (H.R. Rep. No. 34, supra, at pp. 17–18):

"Some life insurance companies compute their life insurance reserves on what is called a preliminary term basis. The effect of this is to take the full agents' commissions (which are larger in the initial period of the life insurance contract) out of amounts which would otherwise be added to reserves during the first year of the contract and to add correspondingly larger amounts to reserves in later years. The effect of this is to work a hardship on insurance companies using preliminary term reserves as compared with those which use ordinary reserves, since the policy and other contract liability deduction depends on the size of the reserves. Moreover, additions to the reserves, deductible under phase 2 [the "gain from operations" computation], also would in some cases be smaller. To avoid this result, life insurance companies which have computed their reserves on a preliminary term basis are permitted to recompute their reserves on a net level premium basis. This can be done either by an exact revaluation of the reserves to a net level premium basis or by approximating this result under a formula set forth in the bill."

The Senate Finance Committee report stressed the importance of this provision to smaller companies (S. Rep. No. 291, supra, at p. 10):

"The House and your committee's bill provide that those establishing their reserves on a "preliminary term" basis may nevertheless for tax purposes convert this to the more liberal "net level premium" basis. This is of primary importance to the smaller companies since it is such companies which predominantly are the users of the preliminary term method."

Because of its importance to the smaller company, we wish to add our voice in support of this provision of the 1959 Act. Without the equalization that this provision produces, small life insurers will suffer a severe competitive disadvantage solely as a result of the operation of the tax laws.

Mr. Chairman, this ends the list of the features of the 1959 Act about which we wish to make specific comment. We would note that each of these features, while both necessary and helpful to small companies, is not unique to the small company setting. There are, however, two elements of the 1959 law which were specifically designed to aid small companies over and above their larger counterparts. These provisions are: (1) the "small business deduction" defined in section 804(a)(3) of the Code, and (2) the "statutory amount" present in the section 809(f) dividend deduction limitation. The SIG proposal suggests that both of these items be amended to the benefit to the smaller companies. We agree with this suggestion, and we think some further comment on it is appropriate.

Under the 1959 Act, all life insurance companies (not only small companies) were allowed a "small business deduction" in the computation of their tax base, equal to 10 percent of their investment yield up to a maximum of $25,000. (A later amendment of the law specified that members of a controlled group of companies were limited to one $25,000 small business amount.) This provision of the 1959 Act, which was patterned after a similar provision in the 1955 "stopgap" law, was intended, according to the Senate Finance Committee report, "to aid new, small and growing businesses" and to ensure that the increase in tax burden under the 1959 Act would not "impede the growth of small and new life insurance companies." S. Rep. No. 291, supra, at p. 9.

As far as small businesses are concerned, the situation since 1959 has not changed, except for the fact that inflation over the years has diluted the value of the $25,000 deduction. Accordingly, we believe it is proper to continue this special small business tax incentive found in the 1959 law, to aid the ability of small companies, whether mutual or stock, to compete with the giants of the life insurance industry. We therefore support the proposal to change the small business deduction of present section 804(a)(3) to allow a company a deduction of $100,000. Furthermore, in order to ensure that this deduction benefits only small mutual and stock companies, we believe (consistent with the SIG proposal) that the deduction should be phased out and should be subject to an affiliated group allocation; under the phase-out in the SIG proposal, companies with an investment yield of up to $1 million would be entitled to the full amount of the deduction, while companies with more than $5 million in investment yield would not receive any benefit from the deduction. Hence, under this regime, the small business deduction would be targeted, for the first time, to small companies only. We think this is a worthy goal and we commend it to the Subcommittee.

With respect to the "statutory amount" in section 809(f), we note that the original $250,000 amount was inserted in the law as a special relief measure for small businesses. The Senate Finance Committee report acknowledged this (S. Rep. No. 291, supra, at p. 9). Thus, to benefit small companies (primarily small mutual companies) with underwriting losses, the limitation on the deduction for policyholder dividends, the deferral for nonparticipating contracts, and the deferral for accident and health and group insurance contracts was set at $250,000 above the excess of a company's "gain from operations" (without regard to the dividend deduction and the special deferrals) over its "taxable investment income."

In the Tax Equity and Fiscal Responsibility Act of 1982, this "statutory amount" was increased to $1 million, but with an appropriate phase-out and with the requirement that it be allocated among members of an affiliated group. NALC companies were actively involved in supporting this change in the 1982 legislation, and we were pleased that Congress saw fit to adopt it, albeit on a temporary basis. The SIG proposal would make this change permanent, a suggestion which we warmly endorse. In addition, that proposal would appropriately correct a technical problem which has arisen in the interpretation of the inter-relation between the phase-out and allocation provision of this statutory change as enacted in 1982. Specifically, the proposal would carry out Congress's original intent by clarifying that the increased "statutory amount" is first allocated equally among the component members of an affiliated group and is then, subsequently, phased out at the individual company level. As active participants in the legislative process last year, NALC companies support this technical correction.

It is true, of course, that if Congress approves the proposal to remove the 1959 Act's limitation on stock companies' dividend deductions and deferral items, this "statutory amount" change would not be of benefit to NALC companies. Nonetheless, we commend to this Subcommittee the proposal to make it permanent, for we think it is of appropriate benefit to smaller mutual life insurance companies. Moreover, if for any reason the proposal to remove the 1959 Act's limitation in the case of stock companies is not fully adopted, then the change in the "statutory amount" made by the 1982 legislation becomes of critical importance to NALC member companies.

In conclusion, Mr. Chairman, we of the NALC are appreciative of the opportunity to testify before you today. In this statement, we have addressed ourselves to those questions in your April 8, 1983, press release which particularly concerned small, stockholder-owned life insurance companies. If you have any questions of us, we will attempt to respond.

MEMBER ROSTER OF NATIONAL ASSOCIATION OF LIFE COMPANIES

Alabama

American Colonial Life Insurance Company, Montgomery, Alabama;
American Educators Life Insurance Company, Birmington, Alabama;
The American Life Assurance Corporation, Montgomery, Alabama;
Bankers Credit Life Insurance Company, Montgomery, Alabama;
Employers Life Insurance Company, Birmingham, Alabama;
Federated Guaranty Life Insurance Company, Montgomery, Alabama;
First National Life Insurance Company, Montgomery, Alabama;
First National Life Insurance Co. of America, Birmingham, Alabama;
Life Insurance Company of Alabama, Gadsden, Alabama;
Old Southern Life Insurance Company, Montgomery, Alabama;

Preferred Life Insurance Company, Montgomery, Alabama;
Southern United Life Insurance Company, Montgomery, Alabama;
Statesman Life Insurance Company, Birmingham, Alabama.

Arizona

Farm and Home Life Insurance Company, Phoenix, Arizona;
American Trustee Life Company of Arizona, Oklahoma City, Oklahoma;
Oxford Life Insurance Company, Phoenix, Arizona;
Western Bankers Life Insurance Company, Scottsdale, Arizona.

Arkansas

The First Pyramid Life Insurance Co. of America, Little Rock, Arkansas;
Greater Carolinas Life Insurance Company, Little Rock, Arkansas;
Providential Life Insurance Company, North Little Rock, Arkansas.

California

California Pacific Life Insurance Company, San Rafael, California;
Commercial Bankers Life Insurance Company, Newport Beach, California;
The Doctors' Life Insurance Company, Santa Monica, California;
E.F. Hutton Life Insurance Company, La Jolla, California;
Transamerica Occidental Life Insurance Company, Los Angeles, California.

Colorado

Capitol Life Insurance Company, Denver, Colorado;
Colorado Bankers Life Insurance Company, Denver, Colorado;
Security Life of Denver, Denver, Colorado;
Western Reserve Life Insurance Company, Grand Junction, Colorado.

Connecticut

Cologne Life Reinsurance Company, Stamford, Connecticut;
General Reassurance Corporation, Greenwich, Connecticut;
Security-Connecticut Life Insurance Company, Avon, Connecticut.

Delaware

Eastern States Life Insurance Company, Wilmington, Delaware.

Florida

American Heritage Life Insurance Company, Jacksonville, Florida;
Charter Security Life Insurance Company, Jacksonville, Florida;
Florida General Life Insurance Company, Coral Gables, Florida;
Guarantee Security Life Insurance Company, Jacksonville, Florida;
Hudson Life Reassurance Corporation, Sarasota, Florida;
Professional Insurance Corporation, Jacksonville, Florida.

Georgia

American Agency Life Insurance Company, Atlanta, Georgia;
American Consumers Life Insurance Company, Atlanta, Georgia;
American Family Life Assurance Company, Columbus, Georgia;
Atlantic & Pacific Life Insurance Co. of America, Atlanta, Georgia;
Cherokee National Life Insurance Company, Macon, Georgia;
Sun Life Group, Atlanta, Georgia;
Life Insurance Company of Georgia; Atlanta, Georgia;
Munich American Reassurance Company, Atlanta, Georgia;
Southern Educators Life Insurance Company, Norcross, Georgia;
Voyager Life & Health Insurance Company, Macon, Georgia.

Illinois

Abraham Lincoln Insurance Company, Springfield, Illinois;
Amalgamated Labor Life Insurance Company, Lincolnwood, Illinois;
American Life Insurance Company, Chicago, Illinois;
Associated Life Insurance Company, Chicago, Illinois;
Central National Life Insurance Company, Jacksonville, Illinois;
Combined Insurance Company of America, Northbrook, Illinois;
Continental Assurance Company, Chicago, Illinois;
Executive National Life Insurance Company, Springfield, Illinois;
Financial Security Life Insurance Company, Moline, Illinois;
Fort Dearborn Life Insurance Company, Chicago, Illinois;

Guarantee Reserve Life Insurance Company, Calumet City, Illinois;
Inter-American Insurance Company, Chicago, Illinois;
Pioneer Life Insurance Company, of Illinois, Rockford Illinois;
Roosevelt National Life Insurance Co. of America, Springfield, Illinois;
The Standard of America Life Insurance Company. Park Ridge, Illinois;
United Founders Life Insurance Co. of Illinois; Rosemont, Illinois.

Indiana

Canyon State Life Insurance Company, Highland, Indiana;
Carnegie Life Insurance Co. of America, Indianapolis, Indiana;
First Equity Security Life Insurance Company, Indianapolis, Indiana;
First United Life Insurance Company, Gary Indiana;
Georgetown Life Insurance Company, Carmel, Indiana;
Great Fidelity Life Insurance Company, Evansville, Indiana;
Greenfield Life Insurance Company, Greenfield, Indiana;
Investors Trust Assurance Company, Indianapolis, Indiana;
Laymen Life Insurance Company, Anderson, Indiana;
Life of Indiana Insurance Company Indianapolis, Indiana;
The Lincoln National Life Insurance Company, Fort Wayne, Indiana;
Lumbermens Life Insurance Company, Indianapolis, Indiana;
Midwestern United Life Insurance Company, Fort Wayne, Indiana;
Society National Life Insurance Company, Indianapolis, Indiana.

Iowa

Life Investors Insurance Co. of America, Cedar Rapids, Iowa;
Life of Mid-America Insurance Company, Dubuque, Iowa.

Kansas

The Centennial Life Insurance Company, Inc., Overland Park, Kansas;
Farm & Ranch Life Insurance Company, Inc., Wichita, Kansas;
First Kansas Life Insurance Company, Newton, Kansas;
National Fidelity Life Insurance Company, Overland Park, Kansas;
The Pyramid Life Insurance Company, Shawnee Mission, Kansas.

Kentucky

American Family Security Insurance Company, Lexington, Kentucky;
Bradford National Life Insurance Company, Lexington, Kentucky;
Commonwealth Life Insurance Company, Louisville, Kentucky;
Continental Trust Life Insurance Company, Owensboro, Kentucky;
Independence Life and Accident Insurance Company, Louisville, Kentucky;
Investors Heritage Life Insurance Company, Lexington, Kentucky;
Kentucky Central Life Insurance Company, Lexington, Kentucky;
Lincoln Income Life Insurance Company, Louisville, Kentucky.

Louisiana

American Liberty Life Insurance Company, Baton Rouge, Louisiana;
Continental Service Life & Health Insurance Co., Baton Rouge, Louisiana;
Guaranty Income Life Insurance Company, Baton Rouge, Louisiana;
Public Investors Life Insurance Company, Alexandria, Louisiana;
Savings Life Insurance Company, Shreveport, Louisiana;
Washington Life Insurance Company of America, Lafayette, Louisiana.

Maryland

The Chesapeake Life Insurance Company, Baltimore, Maryland;
Sun Life Insurance Company of America, Baltimore, Maryland.

Massachusetts

United Educators Life Insurance Company, Framingham, Massachusetts.

Michigan

Lakeland Assurance, Inc., Southfield, Michigan.

Minnesota

American Trustee Life of Minnesota, Minneapolis, Minnesota;
IDS Life Insurance Company, Minneapolis, Minnesota;
The Midwest Life Insurance Company, Minneapolis, Minnesota;
Omaha Financial Life Insurance Company, Minneapolis, Minnesota.

Mississippi

Dixie National Life Insurance Company, Jackson, Mississippi;
State Security Life Insurance Company, Jackson, Mississippi.

Missouri

American Life & Accident Insurance Co. of St. Louis, St. Louis, Missouri;
Business Men's Assurance Company of America, Kansas City, Missouri;
Chase National Life Insurance Company, Springfield, Missouri;
Continental Security Life Insurance Company, Jefferson City, Missouri;
Frankona America Life Reassurance Company, Kansas City, Missouri;
Kansas City Life Insurance Company, Kansas City, Missouri;
Missouri City Life Insurance Company, Kansas City, Missouri;
Public Security Life Insurance Company, Kansas City, Missouri.

Montana

Life of Montana Insurance Company, Bozeman, Montana.

Nebraska

Liberty Americn Assurance Company, Lincoln, Nebraska;
Life of Nebraska Insurance Company, Lincoln, Nebraska;
Lincoln Life and Casualty Company, Lincoln, Nebraska;
Service Life Insurance Company of Omaha, Omaha, Nebraska.

New Jersey

International LIfe Insurance Company, Elizabeth, New Jersey;
New Jersey Life Insurance Company, Saddle Brook, New Jersey;
Resources Life Insurance Company, Fort Lee, New Jersey.

New Mexico

American Home Security Life Insurance Company, Artesia, New Maxico;
Mountain States Life Insurance Co. of America, Albuquerque, New Mexico;
Southwest American Insuance Company, Albuquerque, New Mexico.

New York

Windsor Life Insurance Company of America, New York, New York.

North Carolina

Mid-South Insurance Company, Fayettville, North Carolina.

North Dakota

American Life & Casualty Insurance Company, Fargo, North Dakota.

Ohio

Brookings International Life Insurance Company, Columbus, Ohio;
Grange LIfe Insurance Company, Columbus, Ohio;
The Harvest Life Insurance Company, Middleburg Heights, Ohio;
Midwestern National Life Insurance Co. of Ohio, Cleveland, Ohio;
North American Equitable Life Insurance Company, Columbus, Ohio;
Pan-Western Life Insurance Company, Columbus, Ohio;
Proprietor's Life Assurance Company, Akron, Ohio;
Summit National Life Insurance Company, Arkon, Ohio;
United Liberty Life Insurance Company, Cincinnati, Ohio;
Universal Guaranty Life Insurance Company, Columbus, Ohio;
Westfield Life Insurance Company, Westfield Center, Ohio.

Oklahoma

American Service Life Insurance Company, Tulsa, Oklahoma;
American Standard Life & Accident Insurance Co., Enid, Oklahoma;
American Trustee Life Corporation, Oklahoma City, Oklahoma;
First Life Assurance Company, Oklahoma City, Oklahoma 73126;
Globe Life and Accident Insurance Company, Oklahoma City, Oklahoma;
Mid-western Life Insurance Company, Enid, Oklahoma;
National Foundation Life Insurance Company; Oklahoma City, Oklahoma;
Reserve National Insurance Company, Oklahoma City, Oklahoma;
Security General Life Insurance Company, Oklahoma City, Oklahoma;
Standard Life & Accident Insurance Company, Oklahoma City, Oklahoma;
Trend Life Insurance Company, Oklahoma City, Oklahoma;

United Founders Life Insurance Company, Oklahoma City, Oklahoma.

Oregon

American Guaranty Life Insurance Company, Portland, Oregon.

Pennsylvania

American Independent Life Insurance Company, Wilkes-Barre, Pennsylvania;
Colonial Penn Life Insurance Company, Philadelphia, Pennsylvania;
Congressional Life Insurance Company, Philadelphia, Pennsylvania;
Consumers Life Insurance Company, Camp Hill, Pennsylvania;
National Home Life Assurance Company, Valley Forge, Pennsylvania;
Philadelphia American Life Insurance Company, Philadelphia, Pennsylvania;
Providers Benefit Life Insurance Company, Bala Cynwyd, Pennsylvania;
Union Fidelity Life Insurance Company, Trevose, Pennsylvania;
World Life & Health Insurance Co. of Pennsylvania, King of Prussia, Pa.

South Carolina

Carolina American Life Insurance Company, Charleston, South Carolina;
Carolina Continental Life Insurance Company, Columbia, South Carolina;
The Investment Life & Trust Company, Mullins, South Carolina;
Investors Heritage Life Insurance Co. of the South, Columbia, South Carolina;
Standard Life and Casualty Insurance Company, Rock Hill, South Carolina.

South Dakota

Western Mutual Life and Casualty Company, Rapid City, South Dakota.

Tennessee

The Hermitage Health and Life Insurance Company, Brentwood, Tennessee;
Life and Casualty Insurance Company of Tennessee, Nashville, Tennessee.

Texas

Allied Bankers Life Insurance Company, Dallas, Texas;
American Bankers Insurance Company, Waco, Texas;
American Capitol Insurance Company, Houston, Texas;
American Exchange Life Insurance Company, Dallas, Texas;
American General Life Insurance Company, Houston, Texas;
American Union Life Insurance Company, Dallas, Texas;
Ammest Life Insurance Company, San Antonio, Texas;
Central Security Life Insurance Company, Fort Worth, Texas;
Christian Fidelity Life Insurance Company, Waxahachie, Texas;
Citizens Insurance Company of America, Austin, Texas;
Commercial Travelers Life & Accident Insurance Co., Dallas, Texas;
Connecticut General Life Insurance Company, Dallas, Texas;
Equities International Life Insurance Company, Fort Worth, Texas;
Great Southwest Life Insurance Company, Houston, Texas;
Industrial Life Insurance Company, Dallas, Texas;
Legal Security Life Insurance Company, Mesquite, Texas;
Life Insurance Company of the Southwest, Dallas, Texas;
Lone Star Life Insurance Company, Dallas, Texas;
Mission Life Insurance Company, Houston, Texas;
NTA Life Insurance Company, Dallas, Texas;
National Health Insurance Company, Dallas, Texas;
National Security Life & Accident Insurance Company, Dallas, Texas;
National Western Life Insurance Company, Austin, Texas;
Savers Annuity Insurance Company, Euless, Texas;
Southern National Life Insurance Company, Dallas, Texas;
States General Life Insurance Company, Dallas, Texas;
Statesman National Life Insurance Company, Houston, Texas;
Tower Life Insurance Company, San Antonio, Texas;
Unilife Insurance Company, San Antonio, Texas;
United Bankers Life Insurance Company, Dallas, Texas;
United Fidelity Life Insurance Company, Dallas, Texas;
United Group Insurance Company, Hurst, Texas;
Western General Life Insurance Company, Houston, Texas;
World Service Life Insurance Company, Fort Worth, Texas.

Utah

First Continental Life & Accident Insurance Co., Salt Lake City, Utah;
Security National Life Insurance Company, Salt Lake City, Utah;
Sentinel Security Life Insurance Company, Salt Lake City, Utah;
Surety Life Insurance Company, Salt Lake City, Utah.

Virginia

First Colony Life Insurance Company, Inc., Lynchburg, Virginia;
First Commonwealth Life Insurance Company, Richmond, Virginia.

Washington

Life Insurance Company of the Northwest, Spokane, Washington;
Universal Security Life Insurance Company, Bellevue, Washington.

West Virginia

Applachian Life Insurance Company, Huntington, West Virginia.

Wisconsin

Integrity Life Insurance, Inc., Appleton, Wisconsin;
International General Insurance Corporation, Milwaukee, Wisconsin.

Wyoming

Old Faithful Life Insurance Company, Cheyenne, Wyoming.

Canada

Gerling Global Life Insurance Company, Toronto, Ontario, Canada;
The Mercantile and General Reinsurance Company, plc Toronto, Ontario, Canada;
Pioneer Life Assurance Company, Regina, Saskatchewan, Canada.

Puerto Rico

National Life Insurance Company, San Juan, Puerto Rico.

Chairman **Stark**. Thank you, I appreciate it. I would now call on Mr. Greer for his testimony.

STATEMENT OF ROBERT S. GREER, SR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, UNION NATIONAL LIFE INSURANCE CO., BATON ROUGE, LA., ACCOMPANIED BY F. C. McMAINS, JR., VICE PRESIDENT AND GENERAL COUNSEL, BOTH ON BEHALF OF THE LIFE INSURERS CONFERENCE

Mr. **Greer**. Thank you, Mr. Chairman.

Mr. Chairman and distinguished members of this subcommittee, my name is Robert S. Greer, and I am president and chief executive officer of the Union National Life Insurance Co. of Baton Rouge, La.

I appreciate the opportunity to appear here today, along with the vice president and general counsel of our company, F. C. McMains, Jr., on behalf of the Life Insurers Conference.

The Life Insurers Conference is an association of 88 life insurance companies which provide insurance through the home service system. At this time, I would like to ask that my full statement, along with a list of the membership of the Life Insurers Conference, be placed in the record.

Chairman **Stark**. Without objection, Mr. Greer. If I may inquire at this point, the home service system is what I might have called the debit system years back.

Mr. **Greer**. Yes, it is.

Chairman **Stark**. Thank you.

Mr. **Greer**. At the outset, Mr. Chairman, we would like to stress our agreement with most of the concepts being presented today on behalf of the Stock Company Information Group, the National Association of Life Companies, and the National Insurance Association.

In particular, we support a continuation of the Life Insurance Company Income Tax Act of 1959, as amended by TEFRA, recognizing that several modifications may be necessary. The small companies which we represent are particularly interested in certain of these modifications which we will discuss shortly.

Before turning to the company tax issues, however, we wish to join the many companies and agent witnesses which have appeared before you in the past 2 days in stating our opposition to any attempt to impose a Federal income tax on what is called the inside buildup of the policies that our companies issue.

For nearly three-quarters of a century, the inside buildup of life insurance policies has not been attacked. We are very concerned with suggestions that some have made that this historical treatment was somehow wrong and should be changed.

In a unanimous opinion of the member companies of the Life Insurers Conference, the consistent treatment of the inside buildup since 1913 is correct and sensible and should not be altered.

On the company side, Mr. Chairman, you raised a number of corporate tax questions in your recent press release announcing these hearings.

You have asked, for example, how taxation of investment income and of underwriting income should be combined in a total income approach, how the equity ownership element and policyholder dividends should be treated in the tax laws, what mechanisms should be used to assure that all companies pay their minimum share of taxes, and how the tax laws should reflect differences between net level reserves and preliminary term reserves.

The Life Insurers Conference believes that the answer to each of your questions is found in the concepts embodied in the 1959 act as amended by TEFRA. That law showed how investment income and underwriting income could and should be combined for tax purposes under a total income approach.

It also showed one approach differentiating the redundant premium element from the equity ownership element and policyholder dividends by limiting the deductibility at the corporate level.

Finally, the 1959 act prescribed a means for equalizing the treatment of preliminary term reserves which small companies must hold, with the treatment of net level reserves, which larger companies can hold.

This equalization provision, section 818(c), continues to be of vital importance to my company and to other companies in the Life Insurers Conference.

For these reasons, we support the retention of the 1959 law with changes made by TEFRA as the structure for taxing life insurance companies. A longstanding set of tax rules which has worked well for over 20 years should not be tampererd with lightly.

We think it would be ill-advised to depart from the basic contours of the 1959 law. The 1959 act has over time assured that all companies pay their fair share of taxes. The 1959 act has been an efficient revenue raiser. In our company alone, our income for the years 1978 to 1982 rose 50 percent while our taxes during the same period rose 125 percent.

In your list of questions, Mr. Chairman, you also asked about special provisions for small life insurance companies. The member companies of the Life Insurers Conference suggest two revisions to the 1959 act to assist small businesses.

The small business deduction of section 804(a)(3) should be increased to at least $100,000, subject to an appropriate phaseout to assure that it benefits only small companies.

As in TEFRA, the $250,000 statutory amount under the section 809(f) limitation, should be increased to $1 million, subject to a small business phaseout.

This provision would be intended to benefit small, mutual, and stock companies exclusively, would help small companies to cope better with the special risks and problems they face as small enterprises.

In addition, these provisions would strengthen the competitive position of small companies within an already highly-competitive industry.

This concludes our statement on behalf of the Life Insurers Conference. We wish to thank you for allowing us the courtesy of appearing before you today. We trust that this subcommittee will make adequate provisions, in any tax bill that you report, for the interests of small businesses.

Thank you.

Chairman **Stark**. Thank you very much.

[The prepared statement follows:]

STATEMENT OF ROBERT S. GREER, SR., ON BEHALF OF THE LIFE INSURERS CONFERENCE

Mr. Chairman and distinguished members of this subcommittee, my name is Robert S. Greer, Sr. I am president of the Union National Life Insurance Co. of Baton Rouge, Louisiana. I am appearing here today along with Mr. F. C. McMains, Jr., vice president and general counsel of our company, on behalf of the Life Insurers Conference ("LIC").

The Life Insurers Conference is an association of life insurance companies which provide insurance through the home service system. The purpose of our association, which was originally formed in 1910, is to promote the best interests of present and future home service policyholders, and of our member companies, through the interchange of ideas, the establishment of standards of business conduct in the best interests of policyholders, and the education of the public with regard to the home service system. Currently, the LIC has 88 member companies located in 20 States and the District of Columbia. A roster of our membership is attached to this statement, and we ask that it be made a part of the record.

At the outset, LIC companies wish to stress their agreement with the views that are being presented here today on behalf of the Stock Company Information Group, the National Association of Life Companies, and the National Insurance Association. In particular, we support the proposal of the Stock Company Information Group to continue to tax life insurance companies under the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"), with several modifications. The small companies which we represent are particularly interested in certain of those modifications, upon which we will comment in greater detail shortly. First, however, we wish to make known to you our adamant opposition to any attempt to impose the Federal income tax on what is called the "inside buildup" of the policies that our companies issue.

For nearly three-quarters of a century, dating back to the beginning of the modern income tax, the inside buildup of life insurance policies has not been taxed. We are very concerned with suggestions that some have now placed before Congress that this historical treatment was somehow wrong and should be changed. In the unanimous opinion of the member companies of the Life Insurers Conference, the consistent treatment of the inside buildup since 1913 is correct and sensible in every respect. To demonstrate this, we will now proceed to answer the question in your press release: "What is the historic or social justification for allowing the policyholders to receive tax deferral on the inside buildup in a policy?"

In the first place, we must take issue with the notion, inherent in the question, that "policyholders . . . receive tax deferral on the inside buildup." The primary purpose of a life insurance policy is death protection, and it is to this end that life insurance companies add interest to their life insurance reserves. This interest, together with accumulated net premiums and a pure insurance protection element, comprises the death benefit. It is because this death benefit passes free of tax to the policy beneficiary that the interest element—the inside buildup—is not taxed. The death benefit itself is not taxed out of humane as well as economic considerations: Congress has always recognized that enough problems (financial and otherwise) are associated with the event of death, that it would be highly unfair to impose the income tax as well, and that it is sound social policy to encourage people to take measures against the financial risks associated with death. These and other reasons have counseled against the imposition of tax on the inside buildup.

This brings us to the tax "deferral" available to policyholders. The tax deferral that policyholders may receive during life is really just a reflection of the exclusion of death proceeds granted to beneficiaries. A deferral may be received during life on the buildup of a policy's cash values, and yet these cash values are simply a by-product of the level-premium method of paying for life insurance protection. Life insurers must guarantee cash values to their policyholders because of State law requirements forbidding forfeitures. But all of this serves only to blur the issue. The fact remains that life insurance is purchased to provide financial protection in the event of death, and the Federal tax laws, recognizing this since 1913, have foregone taxing life insurance death benefits (including any inside buildup element). Cash values, and any tax deferrals that they may entail, are of secondary importance at best, and they should not control Congress's decision on the primary issue here.

The congressional decision not to levy a tax on the buildup of death benefit values is of longstanding, and for this reason alone it should not be tampered with lightly. A policy that is based, as we think this one is, preeminently on the desire not to burden any further those families that are faced with the necessity of coping with death, is necessarily a sound and worthy policy. Such a policy has worked very well over the years—there has been no real complaint against it, aside from the quibbling of a few tax theoreticians who have sought to build a perfect world on the basis of a humanly crafted, and therefore imperfect, income tax system.

What's more, even some of those theoreticians have acknowledged that this policy is sound. In a 1971 study for the Joint Economic Committee, Professor Charles E. McClure as much as said this. In that study, Professor McClure concluded that there are many justifications for not imposing a tax on the inside buildup, justifications which remain relevant today. His analysis is a fine one, and we commend it to this subcommittee. The policy against taxing the inside buildup, as Professor McClure points out in his study, encourages financial self-reliance among our population. In a day when Government welfare systems are already strained, such encouragement is highly desirable. Moreover, as Professor McClure also points out, the benefit arising from forebearance of taxation on the inside buildup flows mostly to lower and middle income groups within our population, since these are the people who hold most insurance policies.

This last point, in particular, is of great concern to us. Why should lower and middle income families be further burdened by a new tax on the inside buildup of their life insurance policies? This seems most unfair. We urge this subcommittee to study the comments of the Stock Company Information Group in this respect. Those comments show, we believe, that imposing a tax on the inside buildup will only add to the tax burden of lower and middle income Americans. There can be no justification for doing this.

We could go on at considerable length in listing other historic and social justifications in favor of the present tax treatment of the inside buildup. We might say, for example, that any effort to tax the inside buildup would act to discriminate against life insurance policies, such as whole life, which build up reserves and cash values, and would favor term insurance forms that do not involve any inside buildup. This would amount to a directive from the tax system to buy only those forms of insurance that entail increasing costs over time. The logic of this escapes us. We will stop here with our comments on these points, cognizant that others have made, and are today making, the same points. We trust we have communicated the view of LIC companies that any attempt to tax the inside buildup would be an abominable waste of time and effort. Any such attempt would be misguided and would certainly draw the active, admant opposition of our member companies, their agents, and their policyholders.

At this juncture, Mr. Chairman, we would shift the focus of our remarks to the corporate tax questions that you have raised. You have asked, for example, how taxation of investment income and of underwriting income should be combined in a total income approach; how the equity-ownership element in policyholder dividends should be dealt with in the tax law; what mechanism should be used to assure that all companies pay their minimum share of taxes; and how the tax law should reflect differences between net level reserves and preliminary term reserves. The Life Insurers Conference believes that the answer to each of your questions is found in the law passed by Congress in 1959. That law showed how investment income and underwriting income could and should be combined, for tax purposes, under a total income approach. It showed how to differentiate the redundant premium element from the equity-ownership element in policy-holder dividends, prescribing that the latter, appropriately, should not be deductible at the corporate level. It also showed how to assure that all companies pay their fair share of taxes—the 1959 law has been a highly efficient revenue raiser, by anyone's standards. (The one exception to this, the use of so-called "modco" arrangements under section 820, was adequately dealt with by Congress last year.) Finally, the 1959 Act prescribed a mechanism for equalizing the treatment of preliminary term reserves, which smaller companies necessarily must hold, with the treatment of net level reserves, which the larger companies can hold. This equalization provision, section 818(c), continues to be of vital importance to smaller companies, including all LIC members.

For these reasons, we support the retention of the 1959 law as the structure for taxing life insurance companies. We previously observed in this statement that a long standing set of tax rules which have worked well should not be tampered with lightly. We stated this view in the context of our comments on taxing the inside buildup. We submit, however, that it also applies to the corporate tax rules for life insurance companies. We think it would be ill-advised to depart from the basic contours of the 1959 law.

In your list of questions, Mr. Chairman, you also asked about "special provisions for small life insurance companies." The statement of the National Association of Life Companies discussed two such provisions in considerable detail: The "small business deduction" and the "statutory amount." The member companies of the Life Insurers Conference hold similar views. We wish to note our specific agreement with the proposal of the Stock Company Information Group that:

The small business deduction of section 804(a)(3) should be increased to at least $100,000, subject to an appropriate phaseout to assure that it benefits only small companies, and

As in the 1982 legislation, the $250,000 amount under the section 809(f) limitation should be increased to $1 million, subject to a small-business-oriented phaseout.

Those provisions, which would be intended to benefit small mutual and stock companies exclusively, would help our companies to cope better with the special risks and problems they face as smaller enterprises. (The NALC statement described these risks and problems, and we commend it to you.) In addition, by helping in this manner, these provisions would strengthen the competitive position of small companies within our already highly competitive industry.

This concludes our statement of the views of the Life Insurers Conference. On behalf of the LIC, we thank you for setting out the questions about life insurance company and product taxation that most concern you, and for giving us the opportunity to respond to your questions. We trust that this subcommittee will make adequate provision, in any tax bill that you report, for the interests of small businesses, including small businesses that engage in writing life insurance.

Member roster of Life Insurers Conference

Alabama	
Booker T. Washington	Birmingham
Liberty National Life	Birmingham
Mutual Savings Life	Decatur
National Security	Elba
Protective Industrial of Alabama	Birmingham
Southern Life & Health	Birmingham
Southern United Life	Montgomery
Arizona	
Valley Life & Casualty Ins. Co	Phoenix

Connecticut	
Connecticut General Life	Hartford
General Reassurance	Greenwich
District of Columbia	
Mutual Life of Washington, D.C.	Washington
Peoples Life	Washington
Florida	
Conger Life	Miami
Gulf Life	Jacksonville
Independent Life & Accident	Jacksonville
National Standard Life	Orlando
Peninsular Life	Jacksonville
Georgia	
Coastal States Life	Atlanta
Delta Life	Atlanta
Life of Georgia,	Atlanta
Security Life of Georgia	Macon
United Family Life	Atlanta
Illinois	
Rockford Life	Rockford
United of America	Chicago
Washington National	Evanston
Indiana	
Lincoln National Life	Fort Wayne
Kentucky	
American Life & Accident of Kentucky	Louisville
Commonwealth Life	Louisville
Independence Life & Accident	Louisville
Kentucky Central Life	Lexington
Lincoln Income Life	Louisville
Louisiana	
Central American Life	West Monroe
Central State	Alexandria
Delta Life	New Orleans
Gulf South Life	New Orleans
Kilpatrick Life	Shreveport
Leitz-Eagan Life	New Orleans
Magnolia Life	Lake Charles
Mothe Life	Gretna
Pelican State Life	Jonesboro
Pellerin Life	Breaux Bridge
Rabenhorst Life	Baton Rouge
Riverside Life	Metairie
Security Industrial	Donaldsonville
Southeastern States Life	New Orleans
State National Life	Baton Rouge
Union National Life	Baton Rouge
Maryland	
The Baltimore Life	Baltimore
Home Mutual Life	Baltimore
Monumental Life	Baltimore
Sun Life of America	Baltimore
Michigan	
Mutual of Detroit	Plymouth
Mississippi	
Gulf National Life	Biloxi
Mississippi Funeral Association	Amory
Protective Service Life	Jackson
Missouri	
American Life & Accident of St. Louis	St. Louis
Commonwealth Life & Accident	St. Louis
Reliable Life	St. Louis
New Jersey	
Progressive Life	Red Bank
New York	
North American Reassurance	New York

North Carolina	
Charlotte Liberty Mutual	Charlotte
Durham Life	Raleigh
Home Security Life	Durham
North Carolina Mutual Life	Durham
Pilot Life	Greensboro
Southern Life	Greensboro
Ohio	
Inter-Ocean	Cincinnati
Pennsylvania	
Pioneer Life	Wyncote
Provident Indemnity Life	Norristown
Continental Life Ins. Co	Havertown
South Carolina	
Atlantic Coast Life	Charleston
Liberty Life	Greenville
Pubic Savings Life	Charleston Heights
South Atlantic Life	Charleston
Tennessee	
Life & Casualty of Tennessee	Nashville
National Life & Accident	Nashville
Universal Life	Memphis
Texas	
American National	Galveston
Family Security of America	Fort Worth
Mission Life	Houston
Southland Life	Dallas
Southwestern General Life	Dallas
Virginia	
Equitable Life	McLean
Home Beneficial Life	Richmond
Bahamas	
British-American	Nassau
Family Guardian	Nassau
Puerto Rico	
Atlantic Southern	San Juan
Intercontinental Life	San Juan

Chairman STARK. Our next witness is Mr. George E. Hill, president and chief executive officer of the Winston Mutual Life Insurance Co., representing the National Insurance Association.

Mr. Hill, would you like to proceed?

STATEMENT OF GEORGE E. HILL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, WINSTON MUTUAL LIFE INSURANCE CO., WINSTON-SALEM, N.C., REPRESENTING THE NATIONAL INSURANCE ASSOCIATION, ACCOMPANIED BY DOUGLAS WILLIAMS, ASSISTANT DIRECTOR

Mr. HILL. Thank you, Mr. Chairman.

My name is George Hill, I am president and chief executive officer of Winston Mutual Life Insurance Co., Winston-Salem, N.C.

I am here today on behalf of the National Insurance Association. With me is Mr. Douglas Williams, assistant director of our association. We ask that a written statement we have prepared together with a list of the member companies of our association be made a part of the record of these hearings.

Chairman STARK. Without objection.

Mr. HILL. Our membership consists of both mutual and stock life insurance companies but our member companies have at least one common characteristic, all of us are small businesses when compared to the giant companies of our industry.

In this respect, Mr. Chairman, what we have to say today is quite similar in content to the statements of the other small company associations that are testifying, the National Association of Life Companies and the Life Insurers Conference.

In general, Mr. Chairman, the companies of the National Insurance Association would aline themselves with the positions stated by these other associations.

As regards the inside buildup question, the National Insurance Association wants the members of this subcommittee to know that its member companies stand united against the suggestion that we have heard that the inside buildup should be taxed.

Since other statements delivered here today will detail the reasons why any such suggestion is unsound and unacceptable, we need not repeat these points.

As to the corporate tax rules, the National Insurance Association supports the retention of the structure put in place in 1959. We agree, of course, with the suggestions that have been made by the NALC and the LIC, as well as by the Stock Company Information Group, that Congress should permanently amend the 1959 law to add the changes made in the 1982 law—known as TEFRA—that benefit small companies.

As this subcommittee knows, the 1959 law allows all life insurance companies a policyholder dividend deduction, a deduction for nonparticipating contracts, and a deduction for accident and health and group life insurance contracts, but it makes these deductions subject to a limitation.

That limitation is: $250,000 plus the excess of the "gain from operations"—before taking these deductions into account—over the "taxable investment income."

That $250,000 figure was placed in the law primarily to benefit small life insurance companies, particularly small mutual companies, and it has always been very important to the members of our association.

When Congress enacted TEFRA last year, this figure was increased to $1 million, and at the same time, its benefits were targeted toward smaller companies.

The members of the NIA welcomed the TEFRA changes as both a needed update to account for inflation and an appropriate targeting. We believe that the TEFRA changes should be made permanent, and we therefore recommend that you take this course of action. Small companies need this provision to help them compete with the giants of the industry.

NIA companies also take note of the Stock Company Information Group's proposal that the "small business deduction" provided under the 1959 law—a deduction of 10 percent of the investment yield, not to exceed $25,000—should similarly be updated and targeted.

Under that proposal, the deduction would be increased to a flat figure of $100,000, subject to a phaseout after a company's investment yield exceeds $1 million. We regard this proposal as very helpful to small companies, stock as well as mutual, and we therefore strongly endorse it.

We are of the view that provisions such as these are essential if small life insurance companies, like the member companies of the

NIA, are to survive and are to be able to compete with the large companies in the 1980's.

Beyond this, we also recognize that our survival and economic vitality depend, at a more fundamental level, on the existence of a law that fairly, evenhandedly taxes all life insurance companies, whether mutual or stock, and whether large or small. We believe the 1959 law fulfills this task.

The 1959 law contains a number of provisions that are of great interest to the members of our association, such as the section 818(c) adjustment for preliminary term reserves, the deduction for nonparticipating contracts, and the deduction for A&H and group contracts.

In sum, Mr. Chairman, the National Insurance Association, like the NALC and the LIC, considers the 1959 law the firmest foundation upon which to base the taxing structure for life insurance companies for the rest of this century.

We urge you to adhere to it, and then simply to make the changes suggested by the small company trade associations before you today.

Thank you.

[The prepared statement follows:]

STATEMENT OF GEORGE E. HILL ON BEHALF OF THE NATIONAL INSURANCE ASSOCIATION

Mr. Chairman, my name is George E. Hill, and I am President and Chief Executive Officer of Winston Mutual Life Insurance Company, Winston-Salem, North Carolina. I am here today on behalf of the National Insurance Association ("NIA"), along with Mr. Charles A. Davis, the Executive Director of our Association. The NIA, which was founded in 1921, consists of 32 member companies who have over 11,000 employees and 5 million policyholders. The NIA principally serves the life insurance needs of black families. The stated purpose of our Association is to raise the standards of knowledge and practice within the life insurance industry and to encourage thrift through the purchase of life insurance.

We have attached to this statement a list of the member companies of our Association, and we ask that it be made a part of the record of these hearings. An examination of this list will reveal that our membership consists of both mutual and stock life insurance companies. Such an examination will also reveal that our member companies have at least one common characteristic: all of us are small businesses when compared to the giant companies of our industry. In this respect, Mr. Chairman, what we have to say today is quite similar in content to the statements of the other small company associations that are testifying, the National Association of Life Companies and the Life Insurers Conference.

In general, Mr. Chairman, the companies of the National Insurance Association would align themselves with the positions stated by these other associations. In their statements, both of these organizations have indicated, on the one had, their firm opposition to any efforts to place a tax on the so-called inside build-up of life insurance policies, and, on the other hand, their strong support for the retention of the current corporate tax rules for life insurers, though with a few changes. We agree.

As regards the inside build-up question, the National Insurance Association wants the members of this Subcommittee to know that its member companies stand united against the suggestion we have heard that the inside build-up should be taxed. Since other statements delivered here today will detail the reasons why any such suggestion is unsound and unacceptable, we need not repeat these points.

As the representatives of companies that sell life insurance primarily to black families, we want you to know of our deep concern that the suggested tax would fall most heavily on people whose incomes are at or below the median level for most of our population. The vast majority of our policyholders fit this description. Placing a new tax on these people can at best be regarded as regressive and undesirable. We are most disturbed by the statistics we have seen on this, and we urge this Subcommittee to hold the line, particularly in this instance, against all new tax proposals that would work to the further detriment of lower and middle income people.

As to the corporate tax rules, the National Insurance Association supports the retention of the structure put in place in 1959. We agree, of course, with the suggestions that have been made by the NALC and the LIC, as well as by the Stock Company Information Group, that Congress should permanently amend the 1959 law to add the changes made in the 1982 law (known as "TEFRA") that benefit small companies.

As this Subcommittee knows, the 1959 law allows all life insurance companies a policyholder dividend deduction, a deduction for nonparticipating contracts, and a deduction for accident and health and group life insurance contracts, but it makes these deductions subject to a limitation. That limitation is: $250,000 plus the excess of the "gain from operations" (before taking these deductions into account) over the "taxable investment income." That $250,000 figure was placed in the law primarily to benefit small life insurance companies, particularly small mutual companies, and it has always been very important to the members of our Association. When Congress enacted TEFRA last year, this figure was increased to $1 million, and at the same time its benefits were targeted toward smaller companies—the figure is phased down when the sum of the deductions for policyholder dividends, nonparticipating contracts, and A&H and group contracts exceeds $4 million, and it is totally eliminated when that sum equals or exceeds $8 million. In addition, the $1 million figure is required to be divided among companies that are members of an affiliated group.

The members of the NIA welcomed the TEFRA changes here as both a needed update to account for inflation and an appropriate targeting. We believe that the TEFRA changes should be made permanent, and we therefore recommended that you take this course of action. Small companies need this provision to help them compete with the giants of the industry.

NIA companies also take note of the Stock Company Information Group's proposal that the "small business deduction" provided under the 1959 law—a deduction of 10 percent of the investment yield, not to exceed $25,000—should similarly be updated and targeted. Under that proposal, the deduction would be increased to a flat figure of $100,000, subject to a phase-out after a company's investment yield exceeds $1 million. We regard this proposal as very helpful to small companies, stock as well as mutual, and we therefore strongly endorse it. We think that this proposal, like the TEFRA phase-out of the $1 million figure, appropriately defines a small life insurance company.

We are of the view that provisions such as these are essential if small life insurnace companies, like the member companies of the NIA, are to survive and to be able to compete with the large companies in the 1980s. Beyond this, we also recognize that our survival and economic vitality depend, at a more fundamental level, on the existence of a law that fairly, evenhandedly taxes all life insurance companies, whether mutual or stock, and whether large or small. We believe the 1959 law fulfills this task admirably. A well-functioning structure like the 1959 law, particularly after several permanent changes were made to it by the law enacted last year, should be retained absent some compelling reason to change. We know of no such reason.

The 1959 law contains a number of provisions that are of great interest to the members of our Association, such as the section 818(c) adjustment for preliminary term reserves, the deduction for nonparticipating contracts, and the deduction for A&H and group contracts; we will not bother to list them all. It is sufficient for us to say that we strongly support the retention of that law. We know that some people have criticized it for being too complex (one of this Subcommittee's questions hints that this is so), but our view is that it really isn't the 1959 law that is complex. The complexity actually resides in this business of ours, the business of life insurance. The complications in the 1959 law are simply the complications inherent in our way of doing business.

In sum, Mr. Chairman, the National Insurance Association, like the NALC and the LIC, considers the 1959 law the firmest foundation upon which to base the taxing structure for life insurance companies for the rest of this century. We urge you to adhere to it, and then simply to make the changes suggested by the small company trade associations appearing before you today.

Member roster of National Insurance Association

Alabama		
	Booker T. Washington Insurance Co	Birmingham
	Bradford's Industrial Insurance Co	Birmingham
	Christian Benevolent Insrance Co	Mobile
	Protective Industrial Insurance Co	Birmingham
	Unity Life Insurance Co	Mobile
California		
	Golden State Mutual Life Insurance Co	Los Angeles
Colorado		
	American Woodmen's Life Insurance Co	Denver
Florida		
	Afro-American Life Insurance Co	Jacksonville
	Central LIfe	Tampa
Georgia		
	Atlanta Life Insurance Co	Atlanta
	Pilgrim Health and Life Insurance Co	Augusta
Illinois		
	Chicago Metropolitan Mutual Assurance Co	Chicago
	Supreme Life Insurance Co. of America	Chicago
Kentucky		
	Mammoth Life and Accident Insurance Co	Louisville
Louisiana		
	Benevolent Life Insurance Co	Shreveport
	Gertrude Geddes Willis Life Insurance Co	New Orleans
	Lighthouse Life Insurance Co	Shreveport
	Majestic Life Insurance Co	New Orleans
	National Service Industrial Life Insurance Co	New Orleans
	Peoples Progessive Insurance Co	Rayville
	Purple Shield Life Insurance Co	Baton Rouge
	Reliable Life Insurance Co	Monroe
	Superior Life Insurance Co	Baton Rouge
Michigan		
	Wright Mutual Life Insurance Co	Detroit
Mississippi		
	Security Life Insurance Co. of the South	Jackson
New York		
	United Mutual Life Insurance Co	New York
North Carolina		
	North Carolina Mutual Life Insurance Co	Durham
	Winston Mutual Life Insurance Co	Winston-Salem
Tennessee		
	Golden Circle Life Insurance Co	Brownsville
	Universal Life Insurance Co	Memphis
Virginia		
	Southern Aid Life Insurance Co	Richmond
	Virginia Mutual Benefit Life Insurance Co	Richmond

Chairman STARK. Thank you, Mr. Hill.

I think that your panel's plight is one that the subcommittee is very conscious of, and intends to find a way to accommodate genuine small businesses among you who need assistance.

Unfortunately, our data doesn't tell us exactly what number of life insurance companies paid no taxes in 1981. We can pretty much determine that almost all of those are not in the top 50, so they are the companies that range from minuscule to fairly large, but not the giants.

I guess if you skim the top 50 mutuals and stocks off, you still have a pretty broad range of what, to this chairman, look like pretty big companies.

Most of us, I think, would agree that zero tax is too little, except in very unusual circumstances of a loss or startup situation. I think we all agree with each of you that some phaseout system is fair.

The bigger you get the more you ought to step up to the plate like the big guys in the league and play with the hard ball.

So, my request to each of the panelists is to quantify the definition of a small company. I would like to get a range. I used to be able to do this in the banking business; we used to think of a certain size bank when you could begin to afford your own computer. You had to get to a certain asset size where the president and vice president weren't doing everything. At what size do you have all of the professional personnel you need full time, the adequate headquarters and the office equipment to feel that you are now beyond the threshold where you no longer need the nurturing that a new business needs.

It would just be very helpful to all the members of the committee. If we could start with Mr. Verlander. Please give us your feelings about how big is big and how small is small.

Mr. **Verlander**. That is probably the toughest question we will have, even tougher than defining a life insurance policy or life insurance company.

I would like to try to measure that, not on the basis of assets or on the basis of premium income, but based on the measure of the amount of reserves you may have in your book of business.

That is what we are trying to build, a book of business.

The best way to measure that reserve, I would think, would be what is your investment yield on that reserve. The premiums come in, and we invest them.

I would think a good way to approach it would be on investment income, when investment income reaches x dollars, you have become a medium-sized company, and y dollars, you became a large company.

Our business is so different, we are in a business of David and Goliath. The combined assets of the 300 companies in our association would not equal the assets of any one of the top——

Chairman **Stark**. What is the range, Mr. Verlander?

Mr. **Verlander**. The range will go from $400,000 in gross assets to maybe, we do have some reinsurance companies who have joined with $13 or $14 billion, but then——

Chairman **Stark**. They are mostly associates.

Mr. **Verlander**. $2 million, $3 million, $10 million, $15 million. We are all relatively small, with some at $400,000.

Chairman **Stark**. $50 million?

Mr. **Verlander**. $50 million would be a good-sized company. In our group, there would be very few of those.

Chairman **Stark**. That is very helpful.

Mr. Greer, can you add anything to our——

Mr. **Greer**. I agree it is a very difficult question to answer and how do you judge it? In our particular case, in our Conference, we have companies that go from $167,000 in assets, and we do have one that has——

Chairman **Stark**. Could I ask this: Is there any reason for us to look at the States in which you are licensed to operate? It would seem to me somebody operating in the State of Wisconsin only might not have the same kind of requirements as somebody operating in the State of New York or State of California.

Is that worthy of our looking into in terms of the territorial requirement that you must meet?

Mr. **Greer**. Yes, sir, I think it is. But as far as saying what is a small company, it is all according to who you are comparing it with. It is all relative when you look at the giants, as to what you classify as small. I certainly class our company as small. We have $106 million in assets. I consider it to be very small.

Chairman **Stark**. In your association, what is the range of size?

Mr. **Greer**. $167,000, to the largest of $3 billion.

Chairman **Stark**. Is the $3 billion sort of——

Mr. **Greer**. That is $3 billion total assets of one company.

Chairman **Stark**. Is that unusually large? What is the next one below that, or do you have several big companies?

Mr. **Greer**. It would drop down to—we can furnish you that list of the whole conference, if you desire.

Chairman **Stark**. It would be helpful.

Mr. **Greer**. I would say about $2 billion. But most of the companies would be under the $500 million classification.

Chairman **Stark**. At what size would you phase out? If you could pick asset size, where would you phase out assistance to a small company? $50 million in assets?

Mr. **Greer**. Small company?

Chairman **Stark**. Yes, would you say once you get above $50 million you no longer are small?

Mr. **Greer**. Yes, I think I would base it on investment income as Mr. Verlander testified.

Chairman **Stark**. Mr. Hill.

Mr. **Hill**. Our association is made up of 32 companies and I must add, Mr. Chairman, that some of our companies also are members of the other two trade associations here. We rank the size from approximately $200,000 up to $235 million. We only have one company that falls in that category. We have two companies over $100 million. Everything else is way under the $100 million figure.

Chairman **Stark**. So if I push you, you might say up to $100 million you are small, over that, you are a leader?

Mr. **Hill**. No, we would not.

Chairman **Stark**. How big is your company?

Mr. **Hill**. $5 million.

Chairman **Stark**. Certainly that ought to be included.

Mr. **Hill**. That is right.

We would consider as a perimeter, to at least consider the investment income, not premium income but investment income.

At what level it is hard to say.

Chairman **Stark**. One more question, just yes or no. Do you really need 818(c)(2), if there are other means of reaching a satisfactory tax level for your companies? It seems to me small companies were using it to eliminate a tax disadvantage when they were on a term basis and now, with everyone using the preliminary term basis, is there any reason for it?

Mr. **Verlander**. We need it simply because the first year commission is so high, acquisition costs, medical examinations, policy issues, all go into the first year. If we have to value at preliminary term and then wind up with a little bit of taxation, our total premium cost for the original premium dollar would be right at $1.95.

We say that if it goes in, we will be through with production maybe by April, and I don't know how you hold your field force the other 8 months.

Mr. **Hill**. I concur.

Chairman **Stark**. Thank you.

Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman.

I apologize for arriving late for this panel, but I presume that you are representing the smaller insurance companies.

Mr. **Verlander**. Yes, sir.

Mr. **Schulze**. Do your companies get into these more esoteric forms of insurance, the so-called new look?

Mr. **Verlander**. Some do, but a rather small percentage of our members in the NALC are issuing universal life as an example. Perhaps LIC would like to respond.

Mr. **Greer**. Most of our companies are just issuing regular, routine whole life policies, a few are issuing universal life policies.

Mr. **Hill**. We have no companies issuing such policies in NIA.

Mr. **Schulze**. I would imagine most of your insurance is sold through agents.

Mr. **Hill**. Yes, sir.

Mr. **Schulze**. Local agents?

Mr. **Greer**. All.

Mr. **Verlander**. All.

Mr. **Schulze**. Are they exclusive agents, or do they usually deal with many companies?

Mr. **Hill**. For the most part, in our association, 90 percent are exclusive agents for us.

Mr. **Verlander**. We have never been a big brokerage company. Most of ours are exclusive agents writing with us.

Mr. **Greer**. Virtually all of our agents are exclusive.

Mr. **Schulze**. Are your policyholders more inclined to be of lower income because you are smaller, or does that not have any relationship to the size of the company versus the income level of the purchaser?

Mr. **Greer**. Our basic market in the home service business is the low- and middle-income market, and basically we are taking care of the basic needs, funeral expenses, cleanup expenses, and that type of need. Twenty-five thousand and down size policies is about the range we write in.

Mr. **Verlander**. We write a great deal of our business through payroll deduction privileges granted us by employers where the employee will have $2, $3, $4, or $5 a week deducted from his or her paycheck, remitted to us as premium.

Our policies are smaller and probably from a much lower economic element.

Mr. **Hill**. We have the same, $25,000 and down.

Mr. **Schulze**. Do you have greater opportunities because the bigs are so big, it is the old "hit them where they ain't"? Are you more flexible and able to succeed where they have problems?

Mr. **Greer**. I didn't quite understand your question.

Mr. **Schulze**. Well, smaller companies usually have a great deal more flexibility than large companies.

Mr. GREER. I think as a small company that we can act faster, make faster changes, yes, sir, I do. Of course, we don't have the expertise on our staff that the larger companies have, but I do think we can act faster when we feel it is something that is beneficial to the policyholder and beneficial to our company.

Mr. VERLANDER. It is easier to turn a rowboat around than the U.S.S. *Missouri.*

Mr. SCHULZE. I would also think that perhaps you are closer to your policyholders, and might be able to better give the committee a feel for their thinking. Would it, in your opinion, be better to impose additional taxes at the company level, or the stockholder level, or the policyholder level?

Do you have any thoughts on that?

Mr. HILL. I feel that tax at that level should not happen at all, personally, I have to speak——

Mr. SCHULZE. Policyholder level?

Mr. HILL. Yes.

Mr. SCHULZE. Would that be a roadblock in the sales of your policies?

Mr. HILL. Yes, sir.

Mr. SCHULZE. Make it much more difficult to sell?

Mr. HILL. Yes, sir.

Mr. VERLANDER. I feel like it was said yesterday by someone, this really is the one way that the lower to medium-income person can accumulate something with a little bit of a tax advantage, whereas the wealthy or the near-wealthy can buy tax-free municipal bonds or other things.

Mr. SCHULZE. In effect, you are probably the primary source of savings?

Mr. VERLANDER. Yes.

Mr. SCHULZE. In the lower income group?

Mr. VERLANDER. Yes, sir.

Mr. HILL. Most time, we are the only source.

Mr. SCHULZE. I guess as someone grew financially, they may become more sophisticated, if they don't, you are their source of investment?

Mr. VERLANDER. We find more people are coming in every day at the lower-income level than are moving up to the higher-income level, and I am sure you recognize the same thing.

Mr. SCHULZE. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

I had a chance to browse through the statements that you presented the committee previously, and I was absent for part of the oral testimony, but in the interest of time, I am foregoing questions, Mr. Chairman.

Chairman STARK. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman, I did have two quick points I wanted to make.

I appreciate your testimony, and obviously, small companies are of the utmost importance in this industry.

In looking at the number of companies formed, new companies formed over the last 22 years, it looks like about 100 new companies a year are formed.

I wonder how many of those are formed by existing corporations, subsidiary type of operations? Do you have any information on that?

Mr. Verlander. That is rather easy to get. We can furnish it to you. I know, though, the percentage would be extremely low up until the last year or two. We were formed back in 1956. There were only two of us formed in Florida at that time.

There was a wave of companies being formed then, but each was being formed by an individual group of people, not by existing companies.

[The information follows:]

Sutherland, Asbill & Brennan,
Washington, D.C., May 26, 1983.

Representative Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Washington, D.C.

Dear Mr. Chairman: During the course of the hearings on life insurance company taxation, Representative Ronnie Flippo requested that our client, the National Association of Life Companies, supply for the record figures on the number of new life insurance companies being formed and whether such companies are independent or formed as subsidiaries of existing life insurance companies.

Presented below is an analysis of new life insurance companies formed during the period from June 30, 1981 to June 30, 1982.

NEW LIFE INSURANCE COMPANIES FORMED FOR PERIOD JUNE 30, 1981 TO JUNE 30, 1982 [1]

	Nonaffiliated companies	Formed by life insurance companies	Formed by holding companies	Total
Active companies	64	30	25	119
Inactive companies	17	25	8	50
Total life insurance companies formed	84	55	33	169

[1] These figures are derived from an analysis prepared by the American Council of Life Insurance.

We would be pleased to cooperate with you or your staff in answering further questions on this or other issues.

Yours truly,

William B. Harman, Jr.

Mr. Flippo. I think that information would be very helpful.

The second question I have is that I know of the importance of the ability to adjust reserves by some method, and I am wondering if, since that is a very complex approach, if perhaps the members of your association might be better served to put all of that in some type of small business deduction instead of going through adjustment procedures?

Would you have any views along those lines?

Mr. Verlander. We certainly need the section 818(c) adjustment in order to get our reserve level on a proper basis. It was brought up by someone the other day that the cost of doing that is not so great and that we are in a sophisticated computer age now.

That is highly true for large companies. To them, if the software cost of doing this would be $65,000 to $75,000, that might be a drop in the bucket. Sir, I assure you a $75,000 charge against many of our companies would eliminate the profits or be a sizable portion of the year's bottom line.

Mr. **Flippo**. I am not trying to eliminate the needs that small business has in regard to that, I am saying whatever benefit you get under that wouldn't perhaps be better to put that in a small business deduction rather than for you to have to incur the expense of going through the adjustment.

Mr. **Greer**. Section 818(c) is really a tax deferral. Congress, in its wisdom, has provided for rapid depreciation on buildings. Section 818(c) amounts to the same thing as accelerated depreciation does to the other corporation. It is merely a tax deferral and certainly plays a most important part in the progress of small companies.

Mr. **Flippo**. I thank the gentleman for his response.

Mr. **Guarini** [presiding]. Mr. Duncan.

Mr. **Duncan**. I want to thank the panel. May I ask, did all of your companies pay taxes last year?

Mr. **Greer**. We did.

Mr. **Verlander**. We did.

Mr. **Hill**. We did not.

Mr. **Greer**. We paid $1.3 million.

Mr. **Verlander**. I would suggest a great number of our small companies in the NALC did not pay taxes because they did not have a black bottom line.

Mr. **Greer**. Were you asking specifically for one company or for all in the Conference? We can get you that information.

Mr. **Duncan**. I think it would be helpful if you could, sir.

[The information follows:]

SUTHERLAND, ASBILL & BRENNAN,
Washington, D.C., May 24, 1983.

Congressman FORTNEY STARK,
Chairman, Select Revenue Measures Subcommittee, Committee on Ways and Means, Washington, D.C.

DEAR MR. CHAIRMAN: During the course of the May 11th hearing of the Select Revenue Measures Subcommittee on the taxation of life insurance companies, several members of the Subcommittee asked our client, the Life Insurers Conference, to supply additional information for the record. The LIC response to such requests is as follows:

(1) Tax returns of LIC member companies.—During the course of the hearing, a question was raised by Congressman Duncan as to the amount of federal taxes paid by member companies of the Life Insurers Conference for 1982. We regret that we will be unable to furnish this information to the Subcommittee by the May 29th deadline since the Life Insurers Conference maintains no data on the amount each individual company member paid in federal taxes. Information of this nature would have to be obtained from each company should the Subcommittee need this data at a future date.

(2) Breakdown of LIC member companies by asset size.—In response to your request, we are enclosing a list of member companies of the Life Insurers Conference along with their admitted assets and premium income.

(3) Percentage of publicly traded stock.—During the course of the hearing, Congressman Frank Guarini asked the LIC witness what percentage of the LIC member companies had publicly traded stock. Our research indicates that approximately 45 to 50 percent of the stock life companies within the LIC have publicly traded stock.

On behalf of the Life Insurers Conference we appreciate this opportunity to supplement the oral testimony. Please feel free to advise us should you have any questions regarding this data or should your Subcommittee desire additional information.

Sincerely,

WILLIAM B. HARMAN, Jr.

Enclosure.

MEMBERSHIP OF LIFE INSURERS CONFERENCE: PREMIUM INCOME AND ADMITTED ASSETS, JANUARY 1, 1981 TO DECEMBER 31, 1982

Company	Premium income	Admitted assets
American Life & Acc. of Kentucky	$3,129,566	$89,719,120
American Life & Acc. of St. Louis	1,097,251	9,209,406
American National Insurance Co.	403,531,685	2,741,559,464
Atlantic Coast Life Insurance Co.	5,419,472	30,106,510
Atlantic Southern Ins. Co. of P.R.	6,536,318	18,282,120
The Baltimore Life Insurance Co.	28,011,960	258,802,688
British-American Insurance Co., Ltd.	16,279,528	35,668,697
Booker T. Washington Insurance Company	7,225,679	23,555,073
Central American Life Insurance Co.	2,586,984	8,390,788
Central State Life Insurance Company	3,383,648	22,356,742
Charlotte Liberty Mutual Insurance Co.	15,177,613	48,339,771
Coastal States Life Insurance Co.	44,000,062	140,484,764
Commonwealth Life & Acc. Ins. Co.	23,668,899	103,863,436
Commonwealth Life Insurance Co.	144,963,337	1,174,306,327
Conger Life Insurance Company	5,968,144	11,855,902
Continental Life Insurance Company	1,680,772	2,466,295
Connecticut General Life Insurance Co.	3,609,419,657	15,660,053,539
Delta Life Insurance Co. (La.)	2,246,050	19,661,226
Delta Life Insurance Co. (Ga.)	8,286,672	15,233,361
Durham Life Insurance Company	169,461,491	465,118,463
Equitable Life Insurance Company	39,139,772	348,143,086
The Family Guardian Insurance Co., Ltd	5,402,529	10,126,476
Family Security Insurance Co. of America	3,282,508	15,099,301
General Reassurance Corporation	1,042,397,470	379,389,496
Gulf Life Insurance Company	700,419,274	1,015,132,328
Gulf National Life Insurance Co.	4,520,925	10,073,725
Gulf South Life Insurance Co.	252,406	2,330,460
Home Beneficial Life Insurance Co.	94,501,192	760,190,003
Home Mutual Life Insurance Company	4,625,964	39,976,049
Home Security Life Insurance Co.	62,313,716	237,136,525
Independence Life & Acc. Ins. Co.	5,933,822	10,847,000
The Independent Life & Acc. Ins. Co.	277,360,532	758,386,764
Intercontinental Life Insurance Co. of P.R.	17,152,782	13,348,545
Inter-Ocean Insurance Company	74,382,374	160,725,846
Kentucky Central Life Insurance Company	79,716,069	396,508,702
Kilpatrick Life Insurance Co. of La.	3,575,493	34,509,945
Leitz-Eagan Life Insurance Co. of La.	1,148,135	4,882,043
Liberty Life Insurance Company	133,671,532	583,889,270
Liberty National Life Insurance Co.	297,419,986	1,752,604,693
Life & Casualty Insurance Company	180,361,829	1,113,614,762
Life Insurance Company of Georgia	231,885,276	1,024,177,575
Lincoln Income Life Insurance Co.	39,923,108	104,419,249
The Lincoln National Life Insurance Co.	1,173,565,473	4,914,285,247
Magnolia Life Insurance Company	5,380,597	33,014,436
Mission Life Insurance Company	7,422,769	15,470,181
Mississippi Funeral Assoc. Ins. Co.	3,956,530	12,779,521
Monumental Life Insurance Company	93,764,262	614,257,844
Mothe Life Insurance Company	1,437,550	16,070,134
Mutual of Detroit Insurance Co.	7,252,760	34,139,053
Mutual Life Insurance Co. of Wash. D.C.	1,951,626	10,703,202
Mutual Savings Life Ins. Co.	41,588,250	182,438,952
National Life & Acc. Ins. Co.	423,333,687	3,147,598,616
National Security Insurance Co	7,787,692	30,822,215
National Standard Life Insurance Co.	53,312,435	61,037,095
North American Reassurance Company	81,810,187	495,919,539
North Carolina Mutual Life Ins. Co.	67,192,214	200,051,735
Pelican State Life Insurance Co.	1,113,654	4,683,111
Pellerin Life Insurance Company	549,786	2,098,982
Peninsular Life Insurance Company	45,930,794	206,670,909
Peoples Life Insurance Company	104,683,942	736,030,487
Pilot Life Insurance Company	510,164,147	1,039,632,648

MEMBERSHIP OF LIFE INSURERS CONFERENCE: PREMIUM INCOME AND ADMITTED ASSETS, JANUARY 1, 1981 TO DECEMBER 31, 1982—Continued

Company	Premium income	Admitted assets
Pioneer Life Insurance Company	850,126	2,102,585
Progressive Life Insurance Co.	10,465,349	43,705,247
Protective Industrial Insurance Co.	2,204,334	7,771,323
Protective Service Life Insurance Co.	1,256,867	5,255,427
Provident Indemnity Life Insurance Co.	14,659,606	19,202,407
Public Savings Life Insurance Co.	7,243,315	34,663,735
Rabenhorst Life Insurance Company	1,611,288	13,674,552
The Reliable Life Insurance Company	40,582,132	233,631,172
Riverside Life Insurance Company	6,190,554	36,966,844
Rockford Life Insurance Company	13,663,165	114,721,198
Security Industrial Insurance Co.	18,778,130	75,288,680
Security Life Insurance Co. of Ga.	17,807,364	39,936,103
The South Atlantic Life Insurance Co.	12,477,003	11,186,253
Southeastern States Life Insurance Co.	259,622	2,757,465
Southern Life & Health Insurance Co.	31,101,938	163,217,608
Southern Life Insurance Company	31,355,447	167,995,965
Southern United Life Insurance Co.	8,947,159	27,528,585
Southland Life Insurance Co.	172,887,127	912,215,846
Southwestern General Life Insurance Co.	20,696,062	100,551,389
State National Life Insurance Co.	7,[illegible]92,107	36,902,694
Sun Life Insurance Company of America	91,225,120	529,325,723
Union National Life Insurance Co.	46,094,762	109,899,814
United Family Life Insurance Co.	39,394,291	192,742,835
United Insurance Company of America	293,644,858	1,201,144,275
Universal Life Insurance Company	21,398,576	66,578,087
Valley Life & Casualty Insurance Co.	412,036	749,910
Washington National Insurance Co.	354,408,112	1,245,444,617
Total	11,700,369,287	46,807,403,781

Mr. **Duncan**. Did any of your companies write what we used to call industrial life insurance, collect it from door-to-door?

Mr. **Greer**. Members of our Conference do, yes, sir.

Mr. **Duncan**. Has that type insurance been on the increase in recent years?

Mr. **Greer**. Home service insurance is on the increase, and industrial insurance is declining. I mean most of the home service insurance is on a monthly debit ordinary basis, or weekly ordinary basis, but there is also still a market for the weekly and monthly industrial policy.

Mr. **Duncan**. Mr. Verlander, do you think that the reserves is a matter that should be left solely to the determination by the different States as it is today?

Mr. **Verlander**. Yes, sir. I served as senior insurance examiner many years ago, back in the State of Georgia, and worked in the Georgia insurance department. Those reserves are not exorbitant. They are the minimum reserves that the State insurance department feels should be necessary, and I certainly think that is where that responsibility should lie.

Mr. **Duncan**. Are most States fairly uniform in their requirements?

Mr. **Verlander**. Yes, sir.

Mr. **Duncan**. Do all of you agree that that should be a matter left to the States; do you, Mr. Hill?

Mr. **Hill**. Yes, sir.

Mr. **Verlander**. Yes, sir.

Mr. **Duncan**. Are the dividends that are paid out by the mutual companies to policyholders pretty much the same as the dividends that are paid out by the stock companies?

Mr. **Verlander**. No; I think what I have heard this morning is a correct analysis of a mutual company dividend. Some of that dividend truly is a refund of a redundant premium that was made redundant in order to protect the mutuals against calamities or erroneous mortality tables, but some of it certainly is a return of profits.

Mr. **Duncan**. Do any of you consider that you are at a disadvantage in competing with mutual companies?

Mr. **Verlander**. I consider we would be not only at a disadvantage, we would almost be out of business if they were allowed to deduct 100 percent of their dividends, yes, sir.

Mr. **Duncan**. Rest of the panel care to make any statement?

Mr. **Hill**. I concur, although I am basically with a mutual company. But in terms of our association, it would definitely hurt our stock companies.

Mr. **Greer**. We should be fair with stocks and mutuals.

Mr. **Duncan**. Thank you very much.

Chairman **Stark** [presiding]. Mr. Jenkins.

Mr. **Jenkins**. I want to thank the panel for their testimony. You probably gathered during these hearings that I have some concern about the smaller companies. I know you are laboring under some highly-competitive situations, but of course, Mr. Verlander has a much greater liability, Mr. Chairman, as he chose to go to Georgia Tech as a young man rather than the University of Georgia.

Mr. **Verlander**. Mr. Chairman.

Mr. **Jenkins**. That burden must be shared by a lot of people.

Mr. **Verlander**. The burden is going to get a little bit lighter now that Herschel has signed with New Jersey.

Mr. **Jenkins**. Mr. Verlander, in just plain lay language, if you didn't have the opportunity to set aside under section 818, how would that affect you in acquiring new business?

As I understand it, the actual cost of obtaining new business is a substantial up-front outlay for an insurance company.

Mr. **Verlander**. That is right. I am an old CPA by trade, and the cost of the first year of ordinary business does run somewhere around 175 to 195 percent of the premium.

Mr. **Jenkins**. 175 to 195?

Mr. **Verlander**. Of the first year's premium. If we were not able to, if we had to post, along with that, the higher reserve as well as the higher first-year acquisition cost or if we were not allowed to do that as a tax deduction, we would be at a serious, serious disadvantage.

There is one more thing we have talked about this morning that was put in there simply as a balancing item—the 50-percent deferred. It is more than a balancing item. It is not a tax deduction, it is a tax deferral. If we are one of the giants with 20 million people covered under our mortality table, that is going to work out pretty good every year.

With companies our size, you don't need many deaths in the wrong year. If no one dies this year and without the 50-percent deferral, it looks like we have had a great year. Nobody died.

Next year, or the year after, or the year after that the person is going to die, so we really didn't make money in 1982. We have had an apparent profit in 1982. The day we all get the 20 million covered, the mortality table works pretty well.

But that deferral saves us from reporting a good figure this year, paying taxes, then, January 3, the wrong people die, the highly covered, unreinsured people, and next year, you have a loss.

Whereas, with this 50-percent deferral, the tax wasn't paid and we are protected.

Mr. **Jenkins**. That is a fair answer, sir.

Without huge reserves, and without any huge amounts of income from investments from those reserves, then the only way you can expand is through some ability to transfer part of your operating profit into reserve, tax-free?

Mr. **Verlander**. That is exactly right. If the committee will look at the life insurance dollar among the larger giant mutuals or larger companies, it represents about 30 percent investment income and 70 percent premium income.

With us, it is probably 93 percent premium income, and 7 percent investment income. We are faced with a problem of almost making a profit out of every policy we sell, as opposed to living on the excess interest from tremendous reserves.

Mr. **Jenkins**. So a smaller company cannot be very aggressive unless they have the ability to defer in some way, simply because you don't have the surplus funds over here to draw on to be aggressive. Is that right?

Mr. **Verlander**. That is exactly correct, sir.

Mr. **Jenkins**. My time is up.

Mr. **Hill**. I agree.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Moore.

Mr. **Moore**. Thank you, Mr. Chairman.

I would like to call to your attention and the members of the committee, two constituents and good friends of mine who are members of this panel, Bob Greer and Chuck McMains. I welcome you both to our subcommittee, and am sorry that you come under these circumstances, but maybe we can work this all out.

All three of the organizations represented by the panelists this morning have companies headquartered in my District. I am listening very closely to what you have to say.

It seems to me and the members of the panel, from what I have gathered out of the last day and a half of hearings that everyone is for themselves.

If we have to draw some lines here, let's discontinue the game of everybody being for themselves and let me ask you this question: If we eliminate the third phase of deferral for stock companies, one, is that something you object to? Two, is that something that will affect your individual companies? Three, will it affect larger companies mostly? I think one or two of you have a couple of big company members. I think you indicated that was not indicative of your membership.

Mr. VERLANDER. I heard that too, that section 818(c) is more beneficial to the larger companies. It may be in total dollars, but to us it is survival.

Mr. MOORE. I am not talking about 818(c), I am going to ask you that question. I am of the impression that that benefits the smaller companies more than the larger ones?

Mr. VERLANDER. Yes, sir.

Mr. MOORE. But if I understand, the larger ones say no, if you are going to take it away, take it away from the bottom.

Mr. VERLANDER. You are talking about 50 percent?

Mr. MOORE. Both, since you brought it up. The third phase deferral for companies which, I am led to believe, benefits large companies, and the 818(c)(2) deduction, which it has been recommended we do away with, which primarily benefits the smaller companies.

My first question is, if we have to do away with the third phase deferral, would you object to that, if it doesn't really affect most of your companies?

No. 2, if we do away with 818(c)(2), is it possible, in your mind, for us to retain it for small companies? Those are my two questions. I want each one of you to take a crack at it.

Mr. GREER. I feel that 818(c)(2) is something that is needed for companies our size and around this size, and something that we should have to help us to grow. It is really a tax deferral that enables us to compete with the larger companies.

I do not think it should be phased out unless there is some substitute, just as I mentioned.

In our company, our company alone, from 1978 to 1982, under the present law, our income increased 50 percent but our taxes increased 125 percent.

So, I do feel that we are paying our fair share. But I am thankful that we had 818(c), because without that the tax would have been almost prohibitive for our company. And as far as your question on phase three deferral, we do have $13 million in that area, and it would affect us considerably.

Mr. VERLANDER. My answer is the same, sir. It would affect us considerably. We need 818(c) in order to build reserves and have investment income from those reserves in order to compete, and we need the 50-percent deferral on the same basis.

Mr. MOORE. How much would you have in the deferred category, now?

Mr. VERLANDER. We have about $15 million in deferred Federal taxes for all categories.

Mr. MOORE. Mr. Hill.

Mr. HILL. Yes, sir, I would agree, we definitely need the 50-percent deferral plus 818(c). To answer the last part of your question, I would imagine that some of our member companies have probably around $1 million.

Mr. MOORE. $1 million?

Mr. HILL. Yes, sir.

Mr. MOORE. So, if you were paying taxes on that, that wouldn't necessarily be a big blow to your company?

Mr. HILL. Not as a company, no.

Mr. Moore. The companies seem to indicate that they have no problem with us trying to come up with a statutory definition of life insurance.

Would you have any objections to us trying to do that?

Mr. Greer. No.

Mr. Verlander. Not at all.

Mr. Moore. Anybody have any comments on the proposal to treat a portion of policyholder dividends of mutual companies as a return on equity?

Mr. Hill, you represent a mutual company.

Mr. Hill. Yes, sir.

Mr. Moore. You would probably have a problem with that.

Mr. Hill. I would.

Mr. Moore. I assume that the other two would not.

Mr. Verlander. We certainly would not.

Mr. Moore. They are already driving wedges.

Mr. Verlander. George's problems would be very small, though.

Mr. Moore. I assume we are hitting you like the Secretary of the Treasury did, and the Assistant Secretary, by surprise, on modification of loan and withdrawals rules affecting policyholders. Most of your folks are lower income group policyholders anyway.

You wouldn't have much of a problem in the eyes of the Secretary. Do you have any position on that?

Mr. Verlander. I was surprised at his comments. It is hard to believe that borrowing your loan value on a life insurance policy, which will be charged back to you, which you are paying interest on annually, and which will be deducted from your wife's proceeds when you die, can possibly be considered as income.

It is like going to the bank and borrowing from the bank and taking credit life on it and when I die, it goes against my credit life insurance. I was surprised.

Mr. Greer. I agree.

Mr. Moore. I think that is all.

Mr. Hill. I think all of that will be taken care of when you define life insurance.

Mr. Moore. A good point, Mr. Hill.

Thank you very much, gentlemen.

Chairman **Stark.** Mr. Guarini.

Mr. Guarini. Concerning the method of reevaluating reserves, and Treasury said there shouldn't be, that was my understanding. I am not inclined to agree with them. And I think that you people make a very good case for having some kind of a way of leveling off the disadvantage you have by being small.

But I would like you to give me a little more insight as to how the small companies work. In regard, to the number of companies that are stock companies that have gone public, other than the big three, how many stock companies of the 1,800 stock companies would you say have gone public, are held, file SCC reports, and are regarded as a public company?

Mr. Verlander. If I were to guess, I would say 1,600 or 1,800 or even higher.

Mr. Guarini. Are all of your companies stock that can be bought in the marketplace?

Mr. **Verlander**. Most of ours are stock. A lot of companies in the South——

Mr. **Guarini**. The stock companies?

Mr. **Verlander**. Our stock companies in the South? Originally, many were family owned and have now, with children and grandchildren and so forth, grown into maybe a couple hundred stockholders.

Mr. **Guarini**. You can buy the stock of the companies over-the-counter market or in the marketplace?

Mr. **Verlander**. Some, yes, sir. For example, our company is on the New York Stock Exchange.

Mr. **Guarini**. And because you have the opportunity of sheltering a great deal of money, I imagine the stock prices don't rise very much, do they?

Mr. **Verlander**. It is right that the stock prices do not rise very much.

Mr. **Guarini**. You can defer a lot of income?

Mr. **Verlander**. Most of the stock companies are selling around eight or nine times earnings.

Mr. **Guarini**. The earnings are probably kept very low because you can actually use the reserve process for future liabilities?

Mr. **Verlander**. They are very low.

Mr. **Guarini**. Which is a difficulty of the insurance business.

Mr. **Verlander**. It is not very difficult to keep a small company's earnings low.

Mr. **Greer**. In the Life Insurers Conference, I could get the figures exactly, about 30 to 40 percent are probably privately held. The stock is not on the market. The conference has six mutual companies and the rest of them would be public. I could get you the breakdown.

Mr. **Guarini**. Would you say that the big companies pay the same kind of agency fees to their salesmen and agents that the small ones do? Is there any differential, any advantage there to the big companies to have agencies and salesmen sell their product better than you can?

Mr. **Greer**. I don't think the big ones can sell any better than we can.

Mr. **Guarini**. Do you pay more of an agency commission?

Mr. **Greer**. Well, I will say our agents have a very high average earnings compared to some of the larger companies.

Mr. **Guarini**. Are the fees, the commissions the same from the small companies?

Mr. **Greer**. Basically the same. It is not a lot different. But we do try to be competitive, and it might be in some areas we might pay a little higher.

Mr. **Guarini**. Because you are small, you can probably turn on the dime a lot easier, and could you get out new products a lot quicker and a lot more creativity than the big companies can?

Mr. **Greer**. We don't have the people to do the research on a proposed new product. If we wanted to turn out a new policy, yes, I think we could agree on it faster.

Mr. **Guarini**. But are most of the creative new products coming from the small companies or coming from the big companies?

Mr. **Greer**. I don't know, I couldn't answer that.

Mr. Guarini. Does the bottom line consolidation help the small companies very much?

Mr. Verlander. It wouldn't help many of us, because very few of us have other companies to consolidate.

Mr. Guarini. You as small companies acquire a lot of outside businesses, as some of the big companies have been doing in recent years, getting into banking, getting into real estate, getting into investment.

Mr. Greer. We have not. Strictly all the business that we have is insurance business.

Mr. Guarini. You stick mostly to your own line of selling and writing insurance; is that right?

Mr. Greer. We have a life and a fire company.

Mr. Guarini. Each of the life insurance companies, is it typical for them to operate out of several subsidiaries where they can put the losers with the losers and the better gains with the more sound, structured company.

Mr. Hill. No.

Mr. Guarini. In other words, are you multiple in export setup or do you operate usually out of one particular main company?

Mr. Hill. One main company.

Mr. Greer. One.

Mr. Guarini. Thank you very much.

Chairman **Stark.** Gentlemen, thank you.

Mr. Verlander, just one question.

You mentioned that it cost $1.95 for every premium dollar in the first year. If the policy lapses before the second premium is paid, is any of that $1.95 recaptured?

Mr. Verlander. No, sir.

Chairman **Stark.** That is all in returnable commissions and overrides?

Mr. Verlander. If I may take a moment, sir, on GAPP accounting basis, the acquisition expenses are deferred and spread over the anticipated premium paying period. The month, however, in which that policy lapses, all unamortized first-year acquisition expenses are charged to earnings that year.

The payments of the commissions to the agents are not returnable if the policy does not——

Chairman **Stark.** I didn't know about the general agents, any overrides, conventional expenses or things like that.

Mr. Verlander. No.

Chairman **Stark.** Thank you very much.

I want to thank the panel. This has been most useful and we look forward to working with you as we continue our deliberations.

Mr. Verlander. We appreciate you all letting us appear.

Chairman **Stark.** Our next panel consists of Thomas P. Anderson, Kemper Investors Life Insurance Co. of Chicago; Mr. Joseph Pickering of the IDS Life Insurance Co., Minneapolis; Mr. Alvin Vogel of Charter Security Life Insurance Co. of Chatham, N.J.; Mr. Allan Richards of E. F. Hutton Life Insurance Co., La Jolla; Mr. Robert R. Goode, Jr., of Hartford Life Insurance Co. of Hartford.

Welcome to the committee, gentlemen.

The Chair has been informed that the group here divides into two product areas. In directing our inquiries, we might want to state whether we are directing our questions to Mr. Richards and Mr. Goode, whose companies are involved more in universal life products, as they are called, as opposed to Messrs. Anderson, Pickering and Vogel, whose companies are more concerned with the deferred annuity and annuity products. When you have your questions you might want to direct them to one of the groups or the other; I think it will be helpful to make that distinction.

We will ask you to summarize your testimony in the order that you appear on the witness list, at which time Mr. Anderson is up first. You may proceed in any way you are comfortable.

STATEMENT OF THOMAS R. ANDERSON, CHIEF EXECUTIVE OFFICER, KEMPER INVESTORS LIFE INSURANCE CO., CHICAGO, ILL.

Mr. **Anderson**. Thank you, Mr. Chairman. Good afternoon. My name is Tom Anderson. I am chairman and chief executive officer of Kemper Investors Life Insurance Co., one of two stock life insurance companies in the Kemper Group, and a leading underwriter of fixed and variable annuity contracts—approximately $1.5 billion sold to over 110,000 policyholders.

Because of the time constraints here this afternoon, I will only touch briefly upon some of the points contained in my previously submitted written testimony, which I would request, Mr. Chairman, be admitted as part of the official record here today.

Mr. Chairman, even though both yesterday and today you have indicated that your new approach proposal should not be construed as the sole or most likely legislative proposal to come out of your committee, I do feel obligated to respond to it and to point out some serious problems which we see in it.

As you know, the new approach would separate—or unbundle—life insurance companies into two distinct pieces, underwriting and investments, without the right of offset or consolidation. We believe that this structure creates two very serious problems: First, the lack of offset for underwriting losses—which is inevitable—creates an overstated taxable income; and second, the nondeductibility of interest credits to policyholders effectively disallows the company's greatest real economic cost in the annuity business, with an obvious disastrous result.

In my written testimony, I gave an example—from the company's viewpoint—over a 10-year period of time of the financial results of issuing a $20,000 deferred annuity policy. That example shows that because of these two problems, the company would pay an effective tax of over 300 percent on its pretax economic net income, even though the nominal rate paid would be 46 percent. That, I submit, is confiscatory.

Modification of this new approach does not really solve the problem. Decreasing the applicable corporate income tax rate from 46 to 23 percent would of course help, but cannot totally solve the problem. Increasing the deductible interest rate—up from zero in the proposal—would obviously help, but would still produce an excessive tax rate—well over 50 percent—even though the interest credited to policyholders would have to be reduced. Such a reduction in the crediting rate would probably bring the resulting tax-deferred rate down below the tax-exempt rate on municipal bonds.

Third, taxing policyholders currently on their interest credits, while allowing a full deduction to the company, obviously solves the company's problem—on the surface. But it wouldn't sell any annuities because the public wouldn't buy a product that gives them a negative cash flow.

Therefore, if adopted, the new approach would not accomplish anything constructive. Rather it would: One, impose a totally unfair and confiscatory tax rate on the underwriters of these consumer-oriented products; two, place life companies at a competitive disadvantage in the financial services marketplace, no level playing field; three, fail to generate any additional tax revenue for the Treasury from this segment of the industry since it would cease to exist; and four, tax out of existence one of the best retirement products that is presently available to the American public.

Such a result, it seems to us, would be a tragic one, and somewhat unbelievable at this point in our country's history, when we are struggling so hard to find viable solutions to our social security funding problem.

Life insurance companies, through the annuity product, are able to guarantee—as no other private financial institution is able to do—that the individual will not outlive his financial assets. Why then are we now considering the elimination, through taxation, of this most effective private sector retirement product?

Last fall Congress passed TEFRA which contained several permanent provisions applicable to annuities: First, it reversed the presumed order of withdrawals on annuity contracts so that these withdrawals are considered taxable income, rather than return of principal; and second, it further imposed a 5-percent penalty tax on premature withdrawals.

These changes were made in order to assure everyone that annuity contracts would be used as long-term retirement vehicles instead of as short-term investments.

We concur with the Treasury that these changes were appropriate, and we concur with Mr. John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, who has been quoted in my written testimony, that no further changes are necessary in the annuity area.

It is probably useful to reiterate that annuities do not represent tax avoidance schemes if they are used as intended for long-term retirement purposes.

One, at the time of purchase, no deduction is allowed for premium payments as after-tax dollars are used; two, at the time of early distribution ordinary income taxes and a penalty tax are assessed; three, at the time of a premature death, the beneficiaries must pay ordinary income tax on the asset accumulation; and four, at retirement, the earnings accumulations are taxed at ordinary income tax rates, even though, in the case of variable annuities, a portion of those earnings may have been generated from long-term capital gains.

Picking up on this last point relative to capital gains, I would like to conclude with one last plea.

Please seriously consider the elimination of the effective double taxation that exists on nonqualified variable annuity contracts. These contracts are presently subject to a corporate capital gains tax provision during the accumulation period, even though this income is taxed again upon distribution at ordinary income tax rates.

This represents a very arbitrary and unfortunate disincentive to equity investment in this country, and certainly is not a result that we should strive for as a matter of policy.

Thank you. I will be happy to answer any questions later.

Chairman STARK. Thank you.

[The prepared statement follows:]

STATEMENT BY THOMAS R. ANDERSON, CHIEF EXECUTIVE OFFICER, KEMPER INVESTORS LIFE INSURANCE CO.

My name is Thomas R. Anderson. I am Chief Executive Officer of Kemper Investors Life Insurance Company. Our home office is in Chicago, Illinois. I thank you for the opportunity to present the views of the Kemper Group before the Subcommittee on Select Revenue Measures regarding the various proposals dealing with the taxation of life insurance companies and their products. I speak to you specifically about deferred annuity contracts.

Before I address the annuity issues, I would like to state that the Kemper Group fully endorses the proposals of the Stock Company Information Group. The statements of Hartzel Lebed of CIGNA and the other members of his panel address the specifics of those proposals.

By way of background, Kemper Investors Life Insurance Company has been a leader in the sale of fixed and variable annuity contracts. During the past five years, approximately 110,000 purchasers have entrusted over $1.5 billion of their retirement savings with our Company. In 1981, Kemper Investors Life Insurance Company was the eighth largest annuity writing company.

To understand fully the various proposals currently being advanced, it is essential that we clearly understand the present state of the tax law regarding deferred annuity contacts. On September 3, 1982, President Reagan signed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA, which was designed to generate over $98 billion in taxes over three years, contained certain provisions regarding insurance, some of which were permanent and some of which expire on December 31, 1983. The changes regarding annuity contracts were permanent and involved:

(1) The reversal of the order of withdrawals from an annuity contract so that currently taxable interest income was withdrawn first and then followed by principal, and

(2) The imposition of a 5-percent penalty tax on early withdrawal.

These revisions, which substantially changed the taxation of annuity contracts, were made to guarantee the use of an annuity contract as a long term retirement vehicle, and to prevent perceived abuses regarding the use of an annuity contract as a short term investment vehicle. TEFRA also provided that an insurance company could deduct 100 percent of its interest credited to policyholders. Certainty in the taxation of deferred annuity contracts was finally realized—for the first time in over two years. In addition, tax compliance on annuity contracts was also strengthened through the TEFRA withholding provisions. A certain portion of payments to policyholders would now be withheld.

The Kemper Group believes that perceived abuses of annuity contracts were fully considered by Congress and rectified through TEFRA. We agree with the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, who stated on March 1, 1983 before the Association for Advanced Life Underwriting that with respect to annuity contracts no further tax restrictions are necessary. With respect to the change in the taxing of withdrawals and the penalty tax for early distribution brought about by TEFRA, Mr. Chapoton stated as follows:

"The net effect of these changes is to preserve the benefit of the deferral of tax on earnings through an annuity for traditional deferred annuity contracts, while denying much of this benefit where an annuity is used as a short term investment vehicle. We think that this is a satisfactory solution and we have no plans to seek any further changes in the tax treatment of annuities."

The General Explanation of TEFRA by the Joint Committee on taxation perhaps best sums up Congress' most recent "statement" on annuity contracts:

"Congress believed that the use of deferred annuity contracts to meet long term investment and retirement goals, such as income security, was still a worthy ideal.

However, Congress believed that their use for short term investment and income tax deferral should be discouraged."

The Kemper Group agrees. There can be no doubt that the deferred annuity contract is an important instrument for responsible and conscientious taxpayers in the planning of their own financial security. For this reason, there has been favorable federal tax treatment of annuities for over 70 years since 1913. In 1978, President Carter sent to the Congress a proposal which would have altered this tax treatment by, in effect, taxing the inside build-up on annuity contracts. That proposal was rejected by the full Ways and Means Committee. The annuity contract must be allowed to survive. It should not be taxed to the point where it cannot compete in today's marketplace.

In the past decade, Americans have been increasingly concerned over their future financial security and the means by which they may provide for it. Although the Social Security system may provide a "floor" of protection, it never was intended to, and obviously does not, provide for an individual's total retirement needs. As noted in the second interim report of the President's Commission on Pension Policy, issued in November of 1980, Social Security must be supplemented by other sources of retirement income if a retiree's minimum survival needs are to be met. Although we are not sure that the present revisions are sufficient to completely ensure the long term viability of the Social Security system, we are convinced that any further obstacles to individual retirement planning will exert further pressures on the Social Security system.

The deferred annuity contract is expressly suitable for providing such supplementary income for an individual and his family during retirement years. One of the fundamental purposes of an annuity is the systematic liquidation of an asset. Hence, with an annuity an individual can be guaranteed that he or she will receive an income for life—and be able to negate the risk an the fear of outliving one's income. Because of the lifetime contractual guarantee, an annuity is the most certian, convenient and complete protection against dependency available to an individual today. Furthermore, the variable annuity provides retirees with a viable hedge against future inflation and a chance to share in our rising standard of living. These worthwhile benefits of an annuity contract must not be taxed into extinction, which would be the unavoidable result of significant additional taxation of annuity contracts.

In the savings investment provision of the Economic Recovery Tax Act of 1981, Congress reaffirmed its long standing commitment to the use of tax law to promote growth of savings for retirement. In doing so, it explicitly recognized the need of such savings as a source of funds for capital improvement and economic growth. Annuities have been, are, and should continue to be an important source of this much needed long term investment capital.

Recognizing that the annuity product, therefore, is one of the best and most logical retirement savings vehicles to the general public today (and that the life insurance industry is logically and uniquely equipped to provide such a product), it is particularly disturbing to see a proposed New Approach to life company taxation which would effectively eliminate the deferred annuity product. Congressman Stark's proposal would simply tax the annuity out of existence.

This proposal would separate the operations of life companies into two component parts: (1) underwriting, and (2) investments. Each would be taxed separately, without the right of offset or consolidation. One apparent assumption upon which this proposal is based is that "underwriting operations" should at least break-even. This is not a realistic assumption in the real world in which deferred annuities are marketed. Once one recognizes that the only source of profit on a deferred annuity in its accumulation period is investment income, it is obvious that any and all "underwriting expenses" (such as commissions and maintenance expenses) will generate an "underwriting loss." The inability to offset this loss against investment income generates a disproportionate increase in the life company's tax liability and an effective tax rate (based on true economic pre-tax net income) which can easily exceed 100 percent.

The basic unfairness incorporated into this proposal is then grossly compounded by disallowing any deduction to the company for interest credited to policyholders—even though the cost of these interest credits represents the largest expenses of the underwriting company in a true economic sense. Even if a limited deduction were allowed (such as the 3% interest rate allowed in the proposal for life insurance), the non-deductibility of a significant portion of these interest credits to policyholders still results in a confiscatory tax rate that will clearly exceed 100% of real, economic pre-tax net income—probably in multiples thereof. Again, there is nothing that the company can do to correct this, short of ceasing to offer the deferred annuity product or going out of business.

A simplified numerical example of a $20,000 single premium annuity contract over a 10 year period will help to illustrate the above described problems under this proposal.

10-YEAR CUMULATIVE STATEMENT OF INCOME

	Underwriting	Investment	Total
1. Premiums received	$20,000		$20,000
2. Related reserve increases	(20,000)		(20,000)
3. Commissions paid	(900)		(900)
4. Other underwriting expenses	(650)		(650)
5. Underwriting loss	(1,550)		
6. Investment income		$31,875	31,875
7. Investment expenses		(330)	(330)
8. Investment gain		31,545	
9. Interest credited to policyholders—nondeductible under new approach			(25,220)
10. Book income before tax			4,775
11. Tax liability—(46 percent of investment gain, no offset of underwriting loss)			(14,510)
12. Book loss after tax			(9,735)
13. Effective tax rate (line 11 ÷ line 10) (percent)			304

Obviously, an unlimited number of examples could be given, but for any company heavily involved in the deferred annuity business, the answer is essentially the same—a tax liability that is a quick way to bankruptcy. The only rational thing for a company in this position to do is, of course, to cease marketing deferred annuities. In sum, the new approach proposal would mean the end of deferred annuities and the death of one of this country's best retirement savings vehicles.

Varying the rates (either the deductible interest rate or the tax rate) does little to solve the problem. The only interest rate that is truly useful as a deduction is one that equates to a full deduction for interest credits—which obviously will vary as market interest rates change. And even then, because of the artificial division of the company into two pieces (without the right of offset for "underwriting losses"), the problem is not totally solved.

Congressman Stark's proposal also suggests, as an alternative to non-deductibility of interest credits, that policyholders be taxed currently on the interest build-up in their annuities. While such an alternative would obviously help the company with its disastrous tax problem, the policyholder would be put in the position of paying a tax on income he cannot effectively receive—assuming he wants to retain the basic benefits he acquired with the purchase of his annuity. The policyholder would incur ongoing negative cash flow (because of the tax he would pay) for the privilege of buying the annuity. As a realistic, practical matter, most consumers would not buy the product under these circumstances.

Also implied in this proposal is the idea that the underwriting company can simply reduce the interest rate it credits to policyholders to compensate itself for the increased tax effect of non-deductibility. There are two basic problems with this theory:

(1) As stated above, it is very difficult (and certainly impossible with total non-deductibility of interest credits) to achieve a viable result. Even if 75 percent deductibility were allowed and the company reduced its crediting rate by 30 percent, the effective tax rate over 10 years to the company (using the same example above) would be about 64 percent.

(2) The mathematics for the consumer also do not work—versus other alternatives in the marketplace. Why would an intelligent buyer trying to accumulate funds for retirement or any other purpose buy a deferred annuity with a tax deferred rate of 7 percent or less when this buyer can buy tax-exempt municipal bonds at 8 percent to 10 percent?

In our opinion, therefore, the new approach proposal does not accomplish anything constructive. Rather, such proposal:

(*a*) Imposes a totally unfair and confiscatory tax on underwriters of consumer oriented products where a competitive interest rate is credited on cash values;

(*b*) Places life insurance companies at a significant competitive disadvantage in the overall financial services marketplace (rather than creating a "level playing field");

(*c*) Fails to generate any additional tax revenues for the Treasury from these products since life companies will cease to underwrite these products and/or go out of business totally rather than pay this totally unfair tax;

(*d*) Taxes out of existence one of the best retirement products available to the American public—at a time when this country desperately needs viable alternatives to the disproportionate reliance we have placed on the Social Security system.

Accordingly, the Kemper Group strongly opposes the new approach proposed by Congressman Stark regarding the taxation of life insurance companies and their products. I am advised that members of the ad hoc Committee of Annuity Insurers, a coalition of 18 annuity writing companies of which Kemper is a member, also oppose this proposed change in the tax treatment of annuities.

The Kemper Group supports those present tax provisions for annuity contracts which encourage and foster desirable retirement goals by allowing money to accumulate for retirement on a tax deferred basis. The Kemper Group wishes to stress the fact that the provisions of section 72 of the Internal Revenue Code are not tax avoidance provisions, but rather tax deferral provisions which will be realized by a policyholder only if the annuity is used for its intended long term retirement goals. In addition, premium payments made to a nonqualified deferred annuity contract are from after tax dollars. Thus, no special tax favor is realized through the payment of premium to a deferred annuity contract. Upon distribution, the earnings withdrawn are considered ordinary income even if generated from capital gains and are subject to ordinary income taxation. Thus, upon early distribution, the earnings withdrawn are subject to tax and a 5 percent penalty tax if the withdrawal is made prior to age 59½ and within 10 years of the premium payment. Upon the premature death of the annuitant, the contract value is paid to the beneficiary and the beneficiary is subject to tax on the earnings accumulation. Upon retirement, the earnings represented in each monthly payment are subject to tax. In sum, the annuity tax provisions are not tax avoidance schemes but rather tax deferral provisions which will be realized by a policyholder only if the annuity is used for the desired long term retirement result.

As intimated above, one of the unfair provisions of the current tax law, as it applies to variable annuities (other than those held by qualified plans), is the fact that investment earnings generated from long term capital gains in a variable annuity are penalized by a corporate capital gains tax provision—even though those earnings are fully taxable upon distribution, at individual ordinary income tax rates. This is effectively double taxation and an unfortunate, arbitrary disincentive for equity investment—not a result that we should strive for as a matter of policy. We strongly recommend that the corporate capital gains tax provision during the accumulation period be abolished. We believe that the ordinary income tax applied to all earnings upon distribution is sufficient.

In conclusion, the annuity tax provisions as amended by TEFRA fulfill desirable long term retirement needs of the American people. As we are aware, inflation and the increasing number of older citizens in this country have placed significant burdens on our Social Security system. For many, the annuity provides an essential supplement to public and private pension plans. For others, it provides the only source of retirement income outside of Social Security. The deferred annuity must be encouraged rather than discouraged as a retirement vehicle so that it may continue to play its historical role of providing retirement benefits to the American people.

Chairman STARK. Mr. Pickering.

STATEMENT OF JOSEPH R. PICKERING, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF IDS LIFE INSURANCE CO., MINNEAPOLIS, MINN.

Mr. PICKERING. Thank you. My name is Joe Pickering. I am president and chief executive officer of IDS Life Insurance Co. of Minneapolis, Minn. I have a written statement which I would respectfully request be printed in the record.

IDA Life Insurance Co. is a wholly owned subsidiary of Investors Diversified Services, or IDS. We sell through a nationwide organization of about 4,500 salespeople. The salesforce sells life insurance contracts, sells annuity contracts and various kinds of investments, including face-amount certificates, mutual funds, and various tax shelters.

Our salesforce is trained in the concepts of total financial planning. In total financial planning, an annuity contract is a very important tool which we use and sell for purposes of supplementing retirement income, supplementing retirement income that is going to be received from the person's employer's plan, or social security.

If the customer's needs are for tax-exempt securities or for tax shelters we do not recommend an annuity. Our salesforce has other products which it uses for these desires or needs. The annuity contract is an insurance product. It is a traditional insurance product and has long been recognized as an insurance product in the Federal tax laws.

Insurance, of course, provides financial protection against dying too soon. The annuity contract, in contrast to that, provides financial protection against living too long and thereby outliving one's assets. The annuity contract is used primarily by persons not covered by pension plans or who are inadequately covered by pension plans. This includes people who do not qualify for Keogh plans, or who do not have enough time left in their working career to provide adequately or satisfactorily for their retirement income through individual retirement accounts.

Consequently, I argue that there is no other product that is comparable with an annuity contract. It is truly unique. It is the only product that can provide an income which cannot be outlived. Therefore, to tax increases in the cash surrender value of a deferred annuity would in effect be taxing value that has not been received, value which in fact may never be received, and certainly in any case where it is received would require surrender of the contract and the giving up of valuable insurance protection.

Such contingent incremental increases in cash value do not represent income. Mr. Anderson has already talked about the reform provided under TEFRA last year. These included provisions which did discourage the use of annuity contracts as short term investments or for tax-deferral purposes. I won't go into that any further.

I might comment that it does appear, though, that Congress believed that the use of an annuity for retirement purposes remains a worthy ideal, and I believe that Treasury agrees. Mr. Anderson quoted the public statement of Mr. Chapoton to that effect, and I heard no change in Mr. Chapoton's feelings during his testimony yesterday.

Therefore, I would strongly urge this committee to give the reforms in TEFRA a chance, a chance to prove that it is an effective and efficient means to encourage retirement savings and the creation of investment capital. With one exception, I do not believe there should be any change in the tax treatment of annuities.

That one exception was outlined by Mr. Anderson: namely, the taxation of capital gains under variable annuity contracts. That produces double taxation and is patently unfair. I fully support Mr.

Anderson in his testimony, and I fully support Mr. Lebed in his testimony earlier.

I appreciate the opportunity to express my views, and I also will be happy to respond to questions at the appropriate time.

Mr. GUARINI [presiding]. Thank you, Mr. Pickering.

[The prepared statement follows:]

STATEMENT OF JOSEPH R. PICKERING, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF IDS LIFE INSURANCE CO.

Mr. Chairman, members of the subcommittee, my name is Joe Pickering. I am president and chief executive officer of IDS Life Insurance Co. of Minneapolis, Minnesota. We operate on a nation-wide basis. Although we write the normal lines of life insurance, our business is heavily weighted toward the annuity line—both on a fixed and a variable basis. Our products are sold through a field sales force of approximately 4,500 persons, who also sell the investment products distributed by our parent—Investors Diversified Services—more commonly known as "IDS."

This sales force is trained in the concepts of total financial planning. The annuity contract is a very important instrument in financial planning. It is sold as a means of providing supplemental retirement income—not as merely a way to defer taxes. If the customer's goal is to minimize taxes, our sales representatives offer tax-exempt securities or tax shelters involving oil and gas or real estate.

It is important to distinguish between tax deferral, tax exemption, and tax shelter. The annuity is not a tax shelter; it is purchased with after-tax dollars, i.e., its purchase gives rise to no tax deduction. The annuity is not tax-exempt or tax-free. All income earned on the annuity is taxed when it is received at ordinary income rates.

Perhaps it would be well at this point to review just what an annuity is. The annuity is a traditional insurance product, long recognized as such under the tax laws. In contrast with life insurance, which provides financial protection against the risk of premature death, an annuity provides financial protection against the risk of outliving one's assets by guaranteeing benefits for the lifetime of the annuitant.

While annuities can be purchased on an immediate basis (i.e., with annuity payments commencing shortly after purchase), the great majority are purchased on a deferred basis, which means that annuity payments are scheduled to commence at a future time—such as when the annuitant attains age 65 or 70. Under the deferred annuity, the period prior to the commencement of benefits is generally referred to as the accumulation period. Here, the insurance company assumes a genuine insurance risk from the inception of the contract and bears that risk throughout the accumulation period because the level of future annuity benefits is subject to permanent guarantees reflecting mortality, investment and expense assumptions. Where such permanent insurance guarantees are present, the Internal Revenue Code recognizes that the annuity reserves held by the insurance company are life insurance reserves subject to life contingencies from the outset.

The annuity contract offers a means by which individuals can provide for their retirement years and against the possibility of exhausting their funds. Annuities are especially used by the many persons not covered by pension plans, or who are covered inadequately by pension plans, H.R. 10 plans, or individual retirement accounts. This is particularly true in the case of persons in the latter stages of their working years, people who do not have enough time left using only recently enacted Individual Retirement Accounts to provide adequate retirement incomes for themselves.

The characteristics of the people who purchase annuities from IDS Life in 1982 illustrate this. Buyers who began saving for their retirement on an installment basis—largely IRA customers—had an average age of 44 and made an average payment of $77 per month. If we assume interest is credited at a rate of 10% per year, by age 65 the contract would have a cash value of approximately $65,000, which can be connected to lifetime payments of $650 each month. Consider, however, the individual who is now age 55. If this person were to put $77 per month into an installment annuity, the contract's value at age 65 would be only about $16,000, which would purchase a monthly income of about $160. This is why we, at IDS, find single premium annuities are purchased by older people. Our average single premium annuity customer is 55.4 years old. Those in that age group recognize that monthly savings plans—such as IRA or H.R. 10—will provide an inadequate retirement income unless they are able to supplement it. Many see the desirability of doing just that with a single premium annuity. Our average single premium in 1982 was

$14,625. These people are not the wealthy. They are the people who need the financial security of a lifetime income guarantee.

In the press release announcing this hearing, the question of achieving "comparability with other investments" for insurance company products was raised several times. The concept of the level playing field has also received a great deal of discussion in recent years. I would submit that there is no other product that does what an annuity contract can do—it is a unique instrument. It does not play on the same field as do banks—with their Federal Deposit Insurance Corporation. It does not play on the same field as do the mutual funds—with their complete lack of any guarantees.

Annuities stand on a very different footing from time deposits in a bank or other pure savings or investment vehicles. To tax increases in the cash surrender value of an annuity contract would be to tax the policyholder on value not actually received, which may never be received, and which can be received only through surrender at the cost of relinquishing or diluting valuable insurance protection. Under established tax principles, such unrealized, contingent increments in value simply do not represent income.

Prior to 1982 and the enactment of the Tax Equity and Fiscal Responsibility Act—or "TEFRA," the tax rules permitted the use of deferred annuity contracts for short-term investment purposes. I believe it is widely conceded that there were abuses or excesses in advertising and sales methods to promote the tax-deferred nature of the product and the ability of a contractholder to withdraw his principal without incurring taxes. Some even promoted annuities as a tax shelter.

Congress considered a number of proposals to curb these perceived abuses. It finally concluded that the use of deferred annuity contracts to meet long-term investment and retirement goals, such as income security, was still a worthy ideal. It did act, however, to discourage their use for short-term investment and tax deferral. It did this by changing the way annuity contractholders are taxed at the time some or all of their funds are withdrawn other than as periodic annuity benefits.

One important change was to reverse the tax treatment of a partial surrender of the contract's cash value. Under prior law, the contractholder could treat the amount of a partial surrender or withdrawal as a non-taxable return of capital until he or she had recovered their entire investment in the contract. Under TEFRA, however, the amount of any partial surrender or withdrawal is taxed as ordinary income to the extent of all interest credited on the contract.

A second important change made by TEFRA was the imposition of a 5-percent penalty tax on certain "early withdrawals" from the annuity contract. Generally, the penalty is applied to amounts withdrawn from the contract to the extent they are (1) allocable to a premium paid within ten years, and (2) includible in the contractholder's income. It is important to note that the penalty tax is not imposed on amounts received under circumstances which indicate the annuity was not being used merely as a short-term investment vehicle. No penalty applies if the withdrawal is made after age 59½, death or disability, or in annuity benefit payments spread out over at least a five-year period.

Additionally, by means of Section 264 of TEFRA, Congress resolved the legal uncertainty that had existed as to the ability of life insurers to treat all amounts credited to annuity contractholders as a deductible expense. Under TEFRA, interest guaranteed for at least one year in advance may be treated as interest paid and, thus, fully deductible. According to the report of the Joint Committee on Taxation, Congress took this action because it did not wish to see the marketing of nonabusive retirement annuity contracts curtailed.

TEFRA was signed into law on September 3, 1982. We believe that annuity contracts are now being sold, as Congress intended, primarily for retirement purposes and not in competition with savings or investment instruments. It would appear that the Treasury Department—at least as late as March 1 of this year—was of the same opinion. Assistant Secretary John Chapoton was quoted as saying, "(w)e think (TEFRA) is a satisfactory solution and we have no plans to seek any further changes in the tax treatment of annuities." I strongly urge you to give TEFRA—enacted less than a year ago—the chance to demonstrate that it is an effective and efficient tax policy to encourage retirement savings and the creation of investment capital that is so important to the economic health of this country.

For these reasons, then, with but one exception, I believe that this Subcommittee should take no action to change the present tax laws as they affect annuity contracts. The sole exception is that I believe the taxation of capital gains under a variable annuity contract, as discussed by Mr. Anderson of Kemper Investors Life in his testimony at this hearing, is so egregiously unfair that corrective legislation is needed.

I would close my stating that I am fully supportive of the testimony given at this hearing by Mr. Anderson and that given by Mr. Lebed on behalf of the Stock Information Group.

Mr. Chairman, I appreciate very much this opportunity to express my views and I would be happy to try to respond to any question you or any other member of this Subcommittee may have.

Mr. GUARINI. Mr. Alvin Vogel, chairman of the board and chief executive officer, Charter Security Life Insurance Co's.

STATEMENT OF ALVIN VOGEL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF THE CHARTER SECURITY LIFE INSURANCE COS., CHATHAM, N.J.

Mr. VOGEL. Thank you, Mr. Chairman. I am Alvin Vogel, chairman of the board and chief executive officer of the Charter Security Life Insurance Cos. In 1982 the Charter Company sold more single premium deferred annuities than any other life insurance company, and Charter markets deferred annuities in 49 States and the District of Columbia through a distribution system which includes major stock brokerage firms and independent life insurance agencies.

I have a written statement which I respectfully request be included in the record, and in that statement I say what you have heard many times over the past couple of years. I think I would not like to elaborate on what has been said previously.

With your permission, I would like to focus on what I consider a far more important attitude, and that is a conceptualization of what the annuity is and what it does, because there are some massive, widespread misunderstandings not only on the part of the legislature, but even on the part of my colleagues in the life insurance business who don't write this particular product. I think if I could spend a few minutes in explaining to you what my concerns are, it will refocus your perception on what I consider the real issues to be.

First of all, one of the reasons why there is a widespread misconception is that there is a blurring in the marketplace about who sells financial products. When you have Prudential buying Bache, and you have E. F. Hutton owning E. F. Hutton Life, and when you have Sears in the investment business, there is a blurring on the part of the public about the financial products that are being sold from this financial supermarket, when in fact the reality is that these individual products are very distinct, and even though they are sold out of a single entity, they are administered and regulated by very different agencies.

When a Merrill Lynch broker sells a Charter Security Life annuity, he is not selling it as a Merrill Lynch broker. He is selling it as one of my licensed insurance agents, and the product that he sells is a product that is regulated by the various State insurance departments. When he puts on his other hat and sells stocks and bonds, that is an activity that is regulated by the SEC.

Now, within this blurring there is a misconception that the single premium deferred annuity is an investment, when in fact it is not an investment. It is instead an alternative to an investment. It is the only place where an individual can avoid the investment risk and accumulate funds for his retirement, and then take these funds out over his lifetime, no matter how long that lifetime is.

In accumulating investment funds in generic programs like IRA or the Keogh plans, what he is left with at retirement is a lump sum, and then is confronted with the responsibility of investing that lump sum to provide him with additional retirement income.

If inflation continues the way it has, he might not be able to live off the interest of that investment, and so he starts to take out principal, and as he takes out principal his investment income declines, and then he may very well find himself at age 78 or 80 where he has completely exhausted the funds that he has accumulated through his life.

Now, had he purchased an annuity, he would have gotten this investment income plus an orderly liquidation of principal throughout his life, and I would like to point out to you all that if we run out of his principal because he lives too long, we must continue to make annunity payments for the rest of that life; therefore to lump an annuity with an investment merely because it is sold in this blurred financial marketplace I think is basically an unwarranted assumption.

Another assumption that is commonly made is that an annuity is an increasingly investment-oriented product, and I would like to point out to you that annuities that were sold 30 years ago and annuities that are sold today are equal in form. It is the same contract. The ratio between the interest rates used to calculate annuities in 1953 and the average yield on long-term bonds create a ratio of 91 percent.

Ten years later, in 1963 the interest used was 3.7 and we could earn 4.4. The ratio was 84 percent. Ten years later, in 1973 it was 6.8 percent, and we could have an average yield of 7.6, or a ratio of 89 percent. And finally in 1983 the interest rate used to calculate our annuities was 12 percent, the average yield was 13½, and the ratio was still 89 percent.

Now, if you take this one step further and convert actual dollars from 1953 to 1983, for the same payment the annuitant today gets $113.97 a month, whereas in 1953, when we were calculating 3.2 percent interest, he would have gotten in equal buying power $227.

It is far from being an investment-oriented product. It is merely the reflection of our current economic marketplace, and that the relative ratio of what the profits are to the company and what the annuitant receives are equal in form throughout a 30-year cycle.

The last misconception that I would like to discuss, if I could focus upon it, is the arbitrary division of a single-premium deferred annuity into two parts, the deferred section and then the annuitization section. To separate this into two parts and call one part a savings and the other part something else is not to understand the basic nature of the product.

In ancient days an old philosopher by the name of Zeno proposed a paradox that confounded the philosophical mind for 2,000 years. He presupposed that an archer firing an arrow to a target, it would take a second for the arrow to get there. In a half a second it would be halfway. In seven-eighths of a second it would be seven-eighths of the way there. Since you can divide any number infinitely, the arrow consequently never gets to the target.

Of course, the solution to the paradox is that motion is not a series of infinite stops, but a single process, and the single premium deferred annuity, like Zeno's paradox, is not a series of infinite stops, but a total process of accumulating money during the deferral period for later years to be used as no other product in the world can be used to provide an income for as long as you live.

I think that if we refocus our attention on what the product is and what it does, and cast off the cloud that is put upon it because it is sold through various financial organizations, you can then take the hard material which is at our disposal and come up with an equitable and fair plan for the life insurance business.

Thank you.

Mr. **Guarini**. Thank you, Mr. Vogel.

[The prepared statement follows:]

Statement of Charter Security Life Insurance Co.

My name is Alvin Vogel. I am Chairman of the Board of Directors and Chief Executive Officer of the Charter Security Life Insurance Companies ("Charter"). In 1982 Charter sold more single Premium Deferred Annuities ("deferred annuities") than any other insurance company. Charter markets deferred annuities in 49 states and the District of Columbia through a distribution system which includes major stock brokerage firms and independent life insurance agencies. I wish to present testimony today on the proposed "New Approach" which would disallow any deduction for earnings credited to a policyholder's account established under a deferred annuity contract prior to the annuitization date. We are very concerned that the Subcommittee is reconsidering this deduction issue which was resolved last year by a permanent amendment to the tax law under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") (Public Law 97-248).

I. DESCRIPTION OF DEFERRED ANNUITIES

I would like to begin my statement with a brief description of our product. A customer purchases a deferred annuity for a minimum lump sum cash payment of $5,000. In exchange, he receives periodic income which begins on a date specified in the contract (ordinarily related to his retirement) and ending upon his death. The periodic payments are determined by mortality tables which take into account the annuitant's life expectancy and the contractual interest rate. In contrast, a policyholder of whole life insurance makes equal payments over life so that his beneficiaries will be entitled to a lump sum payment at his death. In the case of deferred annuities, the insurance company bears the risk that the annuitant will live beyond his life expectancy; with whole life insurance, the company bears the risk that the policyholder will die too soon. Both products differ from investments because the ultimate benefits are dependent upon the life expectancy of the participants

II. CURRENT TAX TREATMENT

Current tax law reflects Congressional intent to treat deferred annuities as long-term retirement vehicles and postpone taxation until the annuitant receives his periodic payments.

A. Taxation of earnings

Specifically, § 72 of the Internal Revenue Code ("I.R.C.") provides that as the annuitant receives payments after the annuity starting date, he is taxed on the portion of each payment which is not attributable to his investment in the contract. Thus, the annuitant is not taxed as the earnings accumulate within the insurance company, but is taxed as he receives the annuity payments. As these earnings accumulate, they are credited to the policyholder's account and are excluded from the life insurance company's taxable income pursuant to I.R.C. §§ 804 and 809.

B. TEFRA provisions

Last year Congress reviewed limitations on deductions for earnings credited to policyholder's accounts under deferred annuity contracts. Congress rejected any such limitation because its effect would be to eliminate or substantially curtail the marketing of these retirement products. Moreover, it would result in a cessation or significant reduction of business for some companies. Therefore, Congress permanently amended the Code and permitted a 100 percent deduction of such credited earnings.

However, to ensure that the product would not be abused, Congress made two amendments to § 72 of the Code. Section 72(q) provides for a 5 percent penalty tax on any amount which is taxable to an annuitant upon his receipt of annuity payments within 10 years of his initial investment in the contract.[1] In addition, § 72(e) was amended to provide that partial withdrawals prior to the annuitization date are taxed to the extent of a accumulated earnings first, and the remainder is treated as a return of capital.

III. PROPOSED TAX LIMITATION

The "New Approach" proposes to eliminate the deduction for earnings credited to policyholder's accounts under deferred annuity contracts. As mentioned previously, a 100 percent deduction of such amounts was permanently placed in the law just last year. This proposal is based on the belief that current tax law provides sellers of deferred annuities with a competitive advantage over investment products. While it is true that deferred annuities were given preferred tax treatment, this differentiation was made because Congress recognized that they are not investments, but rather are retirement vehicles. However, the Subcommittee must recognized that current annuities have no greater advantage than they have had in the past.

A. Constant rate of return

Before recent periods of high inflation and high interest rates, life insurance companies paid a 3–6 percent return on deferred annuity contracts. In recent years, companies such as ours have paid 10–12 percent interest on these policies. However, when adjusted for inflation, the current contract rates of 10–12 percent do not result in yields in excess of the 3–6 percent rates historically paid. Moreover, as the following chart indicates, the relationship between interest rates paid on annuities and the average yield on long-term bonds had remained relatively constant.

HISTORICAL COMPARISON OF ANNUITY RATES

[In percent]

Year	Interest rates used to calculate annuity rates (1)	Average yield on long-term bonds (2)	Ratio of (1) to (2) (3)
1953	3.2	3.5	91
1963	3.7	4.4	84
1973	6.8	7.6	89
1983 (January, February)	12.0	13.5	89

B. Reduced purchasing power

The following chart shows that despite the increase in interest rates paid on annuity contracts, there has been a steady decline in effective purchasing power of the dollars received from annuities over the thirty year period.

MONTHLY PAYMENT PER $10,000 FOR MALE 65 LIFE WITH 10 YEAR CERTAIN

	Actual dollars [1]	Adjusted to 1983 dollars
1953	62.24	227.20
1963	64.41	205.38
1973	82.54	181.33
1983	113.97	113.97

[1] Rates were computed using the 1971 individual annuitant mortality table and the interest rates shown in the previous chart. The annuity rates were all calculated using the same mortality table in order to isolate the impact of the interest element of annuity rates.

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[1] This penalty does not apply to periodic payments which will be made over at least 5 years beginning with the annuitization date of payments to an annuitant over the age of 59½.

In fact, even though interest rates used to compute annuity rates have increased between 1953 and 1983, effective purchasing power has decreased by almost 50 percent.

IV. LONG-TERM, RETIREMENT PRODUCT

As indicated above, deferred annuities have been characterized as short-term investments which receive favorable tax treatment. Such characterization ignores the primary purpose of the product—to provide a secure source of income for an individual's retirement years.

A. Long-term aspects

1. Experience.—The "New Approach" proposal is premised upon the belief that most annuitants hold deferred annuities for a few years, obtain tax benefits, and then withdrew their funds. This notion is fundamentally inaccurate. Our policyholders purchase the annuities on a long-term basis to provide adequate retirement income. Our records, which we believe are typical of the industry, substantiate this conclusion. In 1981 partial withdrawals made before the starting date of the annuity (the date on which the company begins payments) totaled less than 1 percent of total assets; and complete withdrawals were less than 3 percent of total assets. Thus, our experience indicates that our policyholders are not abusing our product and using it as a short-term investment.

2. Surrender charge.—In fact, our contracts discourage early withdrawal. If an annuitant withdraws funds prematurely, he must pay a penalty in the form of a "surrender charge." In the first year that charge is equal to 7 percent of the accumulated value of the contract, and it decreases 1 percent annually until it is eliminated after 7 years.

3. Company investment.—Charter's own investment policies provide clear evidence that deferred annuities are long term in nature. In 1982 approximately 82 percent of our company funds were committed to investments for 5 years or more and 45 percent of our funds were invested for 10 years or more. arter would obviously not make these long-term investments if it required short-term liquidity to fund early withdrawals.

B. Retirement aspects

The average middle-class American is finding that Social Security and corporate pension plans will not provide retirement income sufficient to meet his needs. These programs may provide a "floor" of protection, but they will not, in most cases, enable retirees to continue the life style maintined during working years. A deferred annuity therefore provides a valuable source of income to make retirement secure. Corporate pension plans, IRA and Keogh plans and annuities all serve the same function—to provide income for an individual's old age. Corporate pension plans, IRA and Keogh plans are not only permitted to earn interest tax-free on the funds invested, but contributions to such plans are deductible. Thus, to ensure parity among similar retirement plans, the deduction for earnings credited to the policyholder's account should be retained for deferred annuities.

The proposal to eliminate such deductions would require companies to pay a substantial amount of tax on the earnings credited to policyholders, thereby depriving individuals of a reasonable rate of return on annuity contracts. Deferred annuities would be withdrawn from the market; and a viable retirement alternative for middle-income Americans would be eliminated, at a time when most have placed a disproportionate reliance on Social Security.

It is, therefore, essential that this Subcommittee recognize that an annuity is not a short-term tax shelter, but a valuable source of retirement income. Accordingly, the earnings should not be taxed until the policyholder receives his periodic payments as is the case with corporate pension plans, IRA and Keogh plans.

V. RECOMMENDATION

As set forth above, the terms of deferred annuities contracts, the current tax laws, and the intentions of both annuitants and life insurance companies demonstrate that deferred annuities are considered as supplements to retirement income. Therefore, Congress should retain current tax laws applicable to such annuities. In particular, to ensure that deferred annuities will not be abused by investors wishing to obtain short-term tax benefits, arter recommends that Congress retain the 5 percent penalty and the taxation of partial withdrawals to the extent of accumulated interest currently contained in I.R.C. § 72.

Thank you very much.

Mr. GUARINI. Mr. Alan Richards, chairman of the E. F. Hutton Life Insurance Co. of La Jolla, Calif.

STATEMENT OF ALAN RICHARDS, CHAIRMAN, CHIEF EXECUTIVE OFFICER, AND PRESIDENT, E. F. HUTTON LIFE INSURANCE CO., LA JOLLA, CALIF.

Mr. RICHARDS. My name is Alan Richards, president and chief executive officer of E. F. Hutton Life Insurance Co., headquartered in La Jolla, Calif. It is a wholly owned subsidiary of the securities brokerage firm of E. F. Hutton of New York. I, too, have submitted written testimony which I would appreciate being entered into the record.

Hutton Life is the originator of the universal life product which we first introduced in 1978. It now accounts for somewhere between 15 and 20 percent of the total life insurance market in this country. I am here to describe universal life and to explain why its development was inevitable, and why it is so consumer oriented. But before I do, let me state that Hutton Life fully supports the position of the Stock Information Group as regards products generally. I believe that proposal forms a thoughtful, workable and fair basis for the permanent taxation of our business.

When considering universal life, one point must always be kept in mind. Differences between traditional and universal life insurance products are primarily differences of structure and consumer features, not of substance. Universal life is mathematically equivalent to whole life insurance.

The actuarial formulas underlying universal life are demonstrably identical to those underlying all traditional forms of life insurance. In fact, this was recognized by the actuaries of the Internal Revenue Service when we were granted the original private letter ruling affirming that universal life was indeed a form of life insurance.

In fact, it is accurate to describe universal life as a generalized version of the actuarial formulas underlying traditional life insurance products. In other words, it is possible to produce any traditional plan of insurance from the generalized formulas underlying universal life.

Now, the key difference between universal life and traditional policies is the flexibility of premium payments. The flexibility is particularly appropriate in these uncertain economic times. For example, a laid-off employee who has built up a modest cash value can skip a premium or two if he or she wishes without losing the vital coverage which protects the family when they need it the most.

In addition to flexible premiums, universal life has several other consumer-oriented features. These features include the ability to adjust death benefits without the necessity of purchasing a new policy, and therefore incurring first-year loads, and the ability to decrease coverage without incurring additional charges.

Let me just explain the mechanics of a universal life policy. First, the premium is paid. Second, expenses are deducted from the premium. These events all occur monthly. The premium left after expenses are deducted—the net premium—is credited to the cash value. Mortality charges are deducted from that cash value, and interest is credited to the cash value and becomes part of it.

Now, as long as the cash value is greater than the mortality deduction, the policy will continue in force. If the cash value becomes less than the mortality deduction, the policy will lapse unless an additional premium is paid.

I believe the development of universal life was inevitable for these reasons: First, the life insurance industry has been criticized for selling policies which the consumer did not understand. This lack of understanding has led consumers to buy noncompetitive policies in many cases. For example, the 1977 FTC staff study, while flawed in many of its major conclusions, nevertheless showed that there was a wide range of rates of return paid on cash values of permanent life insurance. Universal life is the most understandable cash value policy so far offered. Because it can be understood, consumers find it attractive.

Above all, we initiated the disclosure of the inner workings of the typical permanent life insurance product. All our policyholders receive an annual report which gives in great detail the various components of interest, expense, and mortality charge in addition to the premiums, and that is unprecedented in this business.

Furthermore, commission levels tend to be lower than those paid on conventional products. Next, economic conditions made the issuance of traditional nonparticipating guaranteed cost life insurance by stock companies increasingly difficult. The fluctuations in the interest rates require that we find a way to provide policyholders with the benefits of future estimates of earnings on a competitive basis without guaranteeing dangerously high rates of return far into the future.

Now, initially there was some concern that the very flexibility of universal life could lead to abuses involving excessively investment-oriented products. The relationship between the amount of premiums which can be paid and the cash value which can be accumulated versus the amount of death benefit was addressed by Congress in 1982, in TEFRA.

TEFRA added section 101(f) to the Internal Revenue Code, and its provisions will be discussed in more detail by Mr. Goode. However, a great deal has been said in the last 2 days about current abuses by investment-oriented products, and I want to respond to that.

I think a simple example will demonstrate that universal life can no longer be characterized as an investment-oriented, excessively investment-oriented product, if indeed it ever was. The maximum guideline level premium under TEFRA for a male age 35 purchasing our universal life policy is $15.33 per thousand of insurance. By contrast, the average level premium for participating whole life insurance sold by 25 of our larger competitors is $21.92 per thousand, and that is 43 percent greater.

Furthermore—and I find this most interesting—the actual average annualized premium received by Hutton is considerably less than the $15.33. Actually, since TEFRA it has been $9.46. I think these numbers clearly demonstrate that universal life is not an investment-oriented product. It is not an abusive product. It is merely a better way of meeting traditional life insurance needs.

At Hutton we are very proud of our role in bringing this consumer-oriented life insurance product to the market, and we feel strongly that while the tax laws affecting the life insurance business should of course serve to support conventional products, they should not be so narrowly drawn as to discourage the creativity and innovation which is so beneficial to the consumer.

Thank you.

Chairman STARK. Thank you.

[The prepared statement follows:]

STATEMENT OF ALAN RICHARDS, CHAIRMAN, CHIEF EXECUTIVE OFFICER, AND PRESIDENT OF E. F. HUTTON LIFE INSURANCE CO.

Mr. Chairman and Members of the Subcommittee, I am Alan Richards, Chairman of the Board, Chief Executive Officer, and President of E. F. Hutton Life Insurance Company. I am appearing here today on behalf of my company. E. F. Hutton Life Insurance Company is engaged primarily in the sale of life insurance polices and annuities. The company is licensed to do business in 49 states and the District of Columbia.

I wish to focus my remarks on the relatively new form of life insurance known as "universal life." Hutton Life developed the first universal life policy in 1978. The impetus for this product was our growing awareness of the need of the insurance-conscious public for a more flexible life insurance product, one that could be adapted to the changing needs of insureds as well as to a rapidly changing national economy.

We began marketing the universal life product in late 1978 under the name Complete Life. Because of uncertainties concerning the taxation of the product, we sought and obtained from the Internal Revenue Service a ruling that universal life constituted life insurance for Federal income tax purposes. Once this ruling was issued, sales of the product increased significantly, and therefore a number of other life insurance companies began marketing universal life products.

As a member of the Stock Company Information Group, Hutton Life fully agrees with the testimony and the proposal presented by the representatives of that Group. Rather than repeat the points made by those spokesmen, however, I want to describe a basic universal life insurance policy, and, after providing some background, discuss universal life insurance in the context of the Federal income tax laws.

DESCRIPTION OF UNIVERSAL LIFE INSURANCE

With the exception of flexible premiums, a typical universal life insurance policy does not differ fundamentally from traditional whole life insurance. As with whole life policies, a universal life policy requires an initial premium payment of a minimum amount. The policyholder then determines a schedule of planned periodic premiums. Notwithstanding this schedule, the policyholder may make premium payments at any frequency and, subject to restrictions in the tax laws that I will discuss shortly, in any amount.

The failure to pay premiums according to the planned schedule will not necessarily result in termination or lapse of the policy. However, in the event that the cash value falls below a "monthly deduction" for the mortality and expense charges, the policyholder has a grace period in which to make a premium payment sufficient to cover the monthly deduction. The expiration of the grace period without such a payment will cause the policy to terminate.

The cash value of a universal life insurance policy is determined in a manner consistent with that of whole life insurance, but on a monthly basis. Specifically, on each monthly "anniversary" date, the cash value is recomputed by adding to the prior cash value the sum of all interest credited and the net amount of any premium paid since the prior anniversary date; such net amount equals the actual premium paid reduced by a specified percentage to defray the issuing company's cost of maintaining the policy. The cash value so computed is then reduced by the monthly deduction, which includes an actuarially computed charge for insurance that depends upon the age, sex, and rating class of the insured. The monthly deduction also includes charges for any additional benefits provided by rider and, in some instances, other specified expense charges.

The policy will terminate and the policyholder or beneficiary will become entitled to the payment of proceeds from the policy (1) at the death of the insured, (2) upon surrender, or (3) on a stated maturity date (typically when the policyholder attains the age of 95). Proceeds payable on maturity or surrender equal the policy's cash value less the outstanding balance of any policy loans.

Proceeds payable at death equal the amount of the death benefit provided under the policy less any indebtedness. The policyholder determines the amount of the death benefit, although the death benefit must always exceed the policy's total cash value, i.e., the death benefit will necesarily entail the company's assumption of a pure life insurance risk, just as in the case of whole life insurance. The policyholder may also, within specified limits, increase or decrease the face amount of the policy, although an increase may be subject to presentation of satisfactory evidence of insurability. By permitting adjustment of the death benefit from time to time, the policyholder is accorded additional flexibility in dealing with changing insurance needs within the confines of a single policy. As our sales people tell it, a universal policy is the only life insurance policy an individual will need throughout life.

DEVELOPMENT OF UNIVERSAL LIFE INSURANCE

At the time universal life was first developed, this country was in the midst of an unprecedented inflationary spiral. The need existed for an insurance product that provided insured parties with the flexibility necessary to allow them to cope better with the vicissitudes of inflation and a rapidly changing economy.

Universal life was developed partly in response to this need, and partly to provide consumers with flexibility in premium payments and benefits as just described. Indeed, universal life insurance was designed as a highly consumer-oriented insurance contract. As a popular magazine succintly explained, universal life allows you to "decrease the size of your insurance premium when your household budget is pinched." Money Magazine, "How Sweet Is Universal Life?" (April 1983). In addition, by permitting policyholders to miss premium payments without causing the policy to lapse, universal life has sought to stem the excessive lapse rate of life insurance policies, which had increased from 5.9 percent to 8.1 percent of all life insurance policies between 1970 and 1980.

The extraordinary success of the product to date demonstrates that universal life has cleartly struck a responsive chord and filled a significant need among individuals seeking life insurance. The product is widely hailed as a boon to consumers. Money Magaine called universal life insurance "an almost ideal life insurance policy", and Forbes characterized the policy as "a very good deal for the consumer." In fact, universal life insurance is expected to account for about 15 percent of all new ordinary life insurance policies written this year. Thus, the importance of universal life to the insurance buying public, and to the insurance industry, is difficult to overstate.

As already noted, universal life does not constitute a radical departure from existing life insurance products. Except for flexible premiums, universal life policies resemble traditional whole life insurance. Moreover, the only material difference between traditional whole life insurance and universal life insurance—premium flexibility—is legally insufficient to distinguish the one from the other. In *Haynes* v. *United States*, 353 U.S. 81 (1957), the Supreme Court concluded that insurance products need not have fixed premiums in order for them to be treated as insurance for tax purposes. Thus, from a legal perspective, no justification exists for a tax treatment of universal life insurance that is different from the treatment accorded whole life insurance.

It has been said that the universal life policy "unbundles" the investment component from the pure protection component of the whole life contract. The policy does, indeed, appear to do this—by explaining in the contract, for the first time the mechanics of whole life insurance. However, universal life insurance is mathematically equivalent to traditional whole life insurance. The latter could similarly be "unbundled" without changing its promises or its purpose. The cash values and reserves of traditional whole life policies can be and are calculated using the same formulas as universal life. But neither whole life nor universal life attempts to bundle together two otherwise unrelated components. To the contrary, the investment component is integrally related to the protection component, serving to level and reduce the overall cost of the policy. Without the investment component, the policy holder would face ever increasing costs for insurance protection, ultimately prohibitive in amount. This has been true of whole life insurance for over 200 years, and it is equally true of universal life.

At Hutton Life, we do not view this "unbundling" as anything that is substantively new, for indeed it is not. Rather, we view it more positively, as an important step in providing consumers with an appropriate and needed disclosure. We hope it will give consumers the desired information about how life insurance really works (and always has worked), providing a basis for evaluating and comparing the true merits and costs of cash value life insurance policies.

TAX TREATMENT OF UNIVERSAL LIFE

Despite the similarities between universal life and whole life insurance, concern arose, from a tax policy perspective, that the investment component of universal life could become excessive (i.e., allowing a large cash value build-up without requiring a commensurate amount of pure insurance protection). Some suggested that, for tax purposes, universal life should be treated as something other than life insurance. This approach, however, ignored the fact that, with the exception of flexible premiums, universal life was essentially indistinguishable from traditional cash value life insurance. Moreover, any potential abuse of universal life insurance could be solved by narrowly drawn legislation. Section 101(f) of the Code, added on a temporary basis by the Tax Equity and Fiscal Responsibility Act of 1982, adopted such a focused approach by imposing minimum requirements concerning the degree of insurance risk present in a universal life policy. Hutton Life was actively involved in the development of this provision and strongly supported its enactment.

Under Section 101(f), universal life insurance is treated as life insurance for Federal income tax purposes. As with all other life insurance, the total death benefit is expressly excluded from the beneficiary's gross income. The new provision, however, imposes premium and cash value limitations that limit the availability of such tax treatment to universal life policies used primarily to provide insurance protection. A universal life policy must meet both a "guideline premium" test and a minimum risk amount test in order to qualify as insurance for Federal tax purposes. If either of these tests are not met, the policy will not be taxed as a cash value life insurance policy.

Under the "guideline premium" test, the total premiums paid under a universal life policy cannot exceed the gross premiums payable under a comparable whole life or endowment contract; otherwise, the universal life policy's death benefit will not be fully excludable. More specifically, the sum of the premiums paid at any time must not exceed a specified limit, defined as the greater of the "guideline single premium" or the sum of the "guideline level premiums" to the date of the test. The guideline single premium is the premium at issue of the policy for all future benefits, including permitted additional benefits, based on the mortality and expense rates guaranteed under the policy and on an interest assumption of six percent or the policy's minimum guaranteed rate, whichever is higher. The guideline level premium is the annual premium counterpart of the guideline single premium, computed using the longest premium payment period permitted under the policy (though at least 20 years) and an interest assumption of the higher of the minimum guaranteed rate or four percent.

Under the minimum risk amount test, the death benefit must at all times equal or exceed a specified percentage of the cash value of the policy (before deducting any surrender charge). The percentage mutliple is 140 percent until the insured reaches age 40. Thereafter, the mutliple declines by 1 percent each year, until the insured reaches age 75, when it becomes a level 105 percent.

The guideline premium and minium risk tests constitute a blanced and reasoned approach to the tax treatment of universal life insurance. They alleviate concerns about the potentially excessive investment aspects of universal life. They allow universal life, with appropriate restrictions, to retain its status as life insurance for tax purposes. As a result, the insurance buying public continues to have access to a life insurance product that provides the flexibility that is both desirable and necessary in today's world.

We should note that section 101(f) also contains an alternative test, sometimes called the "cash value" test. Under that test, a policy will be treated as a life insurance contract for tax purposes if the policy's cash value cannot exceed the net single premium for the current death benefit. This test was added to section 101(f), virtually at the eleventh hour of the enactment process, in order to provide an alternative to the guideline premium and minimum risk tests for the benefit of a specific type of policy. That policy is called "adjustable life insurance" and is issued, to our knowledge, by only two companies, the Minnesota Mutual and the Bankers Life of Iowa. Early on in the enactment process, consideration was given to applying this cash value test to the universal life policy, but this was rejected for many reasons.

Specifically, the problem was that the cash value test could in some circumstances requires the policy's death benefit to be greatly increased later in an insured's life. Were this to happen, then, among other things, companies would be forced to assume increasing mortality risks, rather than decreasing ones, at higher ages; reinsurers would undoubtedly be troubled at participating in the assumption of such increasing risks; and companies might well deem it necessary to require medical examination before accepting additional premiums, thereby defeating the benefits of premium flexibility. Perhaps more importantly, policyholders would be forced to accept, and to pay for, additional amounts of insurance coverage (and the associated profit charges) whether or not they are wanted. Thus, it was decided, with prudence, that the treatment of universal life insurance should be governed by the guideline premium and minimum risk tests, not the cash value test.

The Stock Company Information Group proposal makes the standards of section 101(f) permanent. Section 101(f) has proved to be an effective, workable means of settling the tax treatment of universal life insurance, from the standpoint of both the Government and taxpayers. We strongly urge that this proposal be adopted, making section 101(f) permanent.

In addition, the stock company proposal seeks to alleviate uncertainties concerning the tax treatment of so-called "excess" interest credited under universal life policies. TEFRA took an initial step in this regard, assuring stock companies that 85 percent of such excess interest would be deductible, and according them the right to litigate the deductibility of the balance. The stock company proposal makes clear that all amounts paid or credited by stock life insurance companies with respect to their policies would be fully deductible. Allowing a full deduction for amounts paid or credited to customers by stock life companies, inlcuding amounts of excess interest, is entirely consistent with general corporate tax principles: such amounts reduce profits available to shareholders and should, therefore, be deductible by stock companies as an expense of doing business. This clarification is overdue and deserves the prompt approval of Congress.

In sum, we believe that universal life insurance plays an important and ever more significant role in serving the needs of life insurance consumers. We support legislation that would settle, on a permanent basis, the tax treatment of the policyholder, the beneficary, and the company with respect to the universal life contract. The enactment of such legislation, as described in the stock company proposal, would clearly be in the best interest of the Government and the life insurance industry, and, more importantly, in the interest of the consumers of this Nation.

Chairman **Stark**. Mr. Goode.

STATEMENT OF ROBERT B. GOODE, JR., EXECUTIVE VICE PRESIDENT, HARTFORD LIFE INSURANCE CO., HARTFORD, CONN.

Mr. **Goode**. My name is Robert Goode. I am executive vice president of the Hartford Life Insurance Co. and its affiliates. The first thing I want to say is that I do support the position of the Stock Information Group as set forth this morning by Mr. Lebed.

I want to specifically talk about the tax issues involved in universal life insurance. Our company is indeed a major writer of universal life. There isn't any organization, any formal organization of universal life insurance writers, but I am confident that I speak for most, if not all, of the companies actively in that market, and we are all concerned that this product, the universal life product, be taxed at the policyholder level on a basis consistent with the basis for traditional life insurance policies.

Alan has described universal life insurance and particularly the consumer-oriented features of the product, and has emphasized, as I do, that it is indeed not an investment-oriented product.

Now, the primary Federal income tax issue involved with universal life is the treatment of the death proceeds from such policies and the application of the section 101 exclusion that we have been talking about for the last couple of days.

Alan referred to the private letter ruling that a policyholder of E. F. Hutton Life Insurance Co. received in 1981, and that ruling did say that all of the proceeds of the universal life policy were death proceeds for purposes of the application of section 101, an interpretation with which I agree.

The ruling was reconsidered in mid-1982, that is, the Hutton ruling, probably because of perceived abuses of the universal life insurance policy.

Back to the investment orientation. The example that was around and discussed, when TEFRA was being considered, was the famous million-dollar premium for $1,010,000 of life insurance. Clearly that is an abuse. I don't know if there were any such cases. We certainly never saw one, but the opportunity was there, and we, the insurance companies, felt that we had to do something about it. I would point out that that came at the very time that TEFRA was being discussed by you people.

My company and others advocated the establishment of some firm guidelines which would eliminate the opportunity for abuse by defining a life insurance policy whose proceeds would qualify for the 101 exclusion. We worked closely with the tax legislative counsel at the Treasury. We worked within the life insurance trade association. The mutuals, the stocks, the universal life writers all worked together and developed these guidelines which were then written into TEFRA as one of the temporary provisions.

The guidelines involve some rather complex, complicated tests to determine whether a universal life insurance policy has enough risk element within the policy to justify the exclusion. In general, the tests require, first, that the premiums are similar to traditional life insurance premiums to provide the benefits. Alan gave a numerical example.

The second part of the test is that there must be a material life insurance risk involved. The face value of the policy must be at least 140 percent of the cash value at ages through 40 and the requirement then grades down with age. Details of these tests are included in my written statement which you have.

Now let me emphasize one further point about them: that the guidelines in section 101(f), to which you have referred several times in the last couple of days, apply only to flexible premium policies, typically universal life insurance policies.

Mr. Chapoton's written statement yesterday indicated that the guidelines for these flexible premium policies are an example of the kinds of tests that could be used in the definition of life insurance. There was some contradiction in his oral testimony, but I think this is what he had in mind.

Your staff in the last day or so has been furnished a definition recommended by the mutual company group that would discard the guidelines that were incorporated in TEFRA. It is my opinion that that proposal, which you just received, was designed to put the universal life insurance product at a severe competitive disadvantage, that is all it was about, and it was even designed to put us out of the universal life business, a longstanding objective of certain mutual companies.

That cash value test simply is unfair. It doesn't work. There are a number of complications in it that I won't go into, but it just is not a workable test. There is an industry group already at work to expand the guidelines on a reasonable basis to conventional policies.

The guidelines that were included in TEFRA have worked very well. There is nothing wrong with them as they apply to flexible premium policies. They do provide a level playing field for universal life policies and traditional life policies. It is imperative that they be made permanent in any new tax legislation. To do otherwise would jeopardize the product, the most consumer-oriented new life insurance product to emerge in many years.

Thank you for the opportunity to testify.

Chairman STARK. Thank you, Mr. Goode.

[The prepared statement follows:]

STATEMENT OF ROBERT B. GOODE, JR., EXECUTIVE VICE PRESIDENT, HARTFORD LIFE INSURANCE CO., HARTFORD, CONN.

The scope of this statement is limited principally to taxation of universal life insurance products, the effect of TEFRA provisions upon such products, and the possible extension of TEFRA premium guidlines to other forms of insurance products. My company endorses testimony of other witnesses appearing before this Subcommittee who favor the use of the 1959 Life Insurance Company Tax Act as a point of departure for modifications to be developed by this Subcommittee. I am confining this statement to narrower ground in the interest of sparing the Subcommittee repetitive reading.

Before proceeding to the area of my special interest, I do want to record my Company and its life insurance affiliates as being opposed to the proposal that was discussed by Congressman Stark at a Subcommittee briefing on April 7, 1983 (hereafter the "Stark Propossal"). As we understand the Stark Proposal a separate tax on investment income and on underwriting income is offered, with no offset between the two tax bases for underwriting losses. Most growing life insurers encounter underwriting losses. Certainly, substantial underwriters of group life and health insurance risks encounter losses from underwritng which investment of premium funds is expected to offset. Further, the Stark proposal permits no deduction for annuity reserves. In respect to our four affiliated life insurance companies, the Stark Proposal would increase the federal income tax due, based upon a calculation method approved by Joint Committee staff, by a factor of seven i.e. from $6,000,000 to $42,000,000 (based on 1981 income). An increase of such magnitude can not possibly be defended.

I. BACKGROUND OF UNIVERSAL LIFE

Proceeds of life insurance contracts payable by reason of the death of the insured generally are excluded from gross income (IRC § 101(a)). No definition of the contracts entitled to this exclusion was provided in Section 101 (or regulations thereunder) prior to enactment of TEFRA. Nevertheless a great variety of life insurance plans have been sold and millions of taxpayers have relied upon the exclusion of death proceeds from income in planning their financial affairs and purchasing life insurance. Among the plans marketed were fixed premium "whole life" policies, under which premiums are payable for the whole duration of life, until the attained age at end of the mortality table used to calculate reserves for the policy. This plan can be described as an endowment at the attained age at the end of the mortality table, that is, the cash value of the policy equals the face value at the age at which the mortality table ends. Endowments at younger ages are similar in concept to a whole life policy. They simply reach the point earlier at which cash value and face value become identical (and the face value becomes payable as an endowment). Thus endowments at earlier ages have a greater cash value element.

Some companies have marketed a plan of life insurance called retirement income (an endowment annuity). This plan contemplates that the cash value will increase to a point where it exceeds the face value (with the higher of cash or face value being payable at death). At maturity of the endowment while the insured is still alive, the cash value is applied to provide annuity payments. Under existing rules death proceeds of annuity contracts are not excluded from income. The Treasury Department appears to have some reservations about whether the death proceeds of this plan of insurance should be excluded from gross income after the cash value exceeded the face value.

In recent years the rates of interest credited to cash value by insurers issuing fixed premium whole life policies have not kept up with inflation. Further, the plans of insurance available to the public were distinct from one another, limiting the ability of the policyholder to adjust his policy to meet changing insurnace needs. To remedy these deficiencies, several insurers developed a single policy design that encompassed nearly all possible plans of insurance i.e. a universal life insurance policy. The result is a flexible premium adjustable benefit life insurnace policy. Since this policy had the capability of producing a cash value like that of the endowment annuity i.e., in excess of the initial face amount, its designers insured exclusion of the death proceeds under IRC Section 101 by designing a face value that always exceeded the cash value.

A universal life policy in concept includes in one policy all plans of life insurance, from term insurance through whole life to endowment plans, from single premium through annual premium to monthly premium. This is accomplished by permitting premiums which may be paid in varying amounts and at any time. Further, the level of insurance may be varied by adjustment to the policy without the necessity of issuing a new or separate policy. The costs of the risk coverage (i.e., the face value of the policy less its cash value) are funded from the cash value or premiums. Hence if a term insurance result is desired, minimum premiums may be paid only when it is necessary to maintain the policy in force. If annual premium whole life insurance is desired, premiums are paid annually in the necessary amount. If an endowment at an age earlier than 100 is desired, an earlier maturity can be specified. The flexibility of the policy is inhibited only by the need to qualify the death proceeds of the policy for exclusion under Section 101.

Marketers of universal life insurance policies sought private letter rulings from the Internal Revenue Service with respect to the exclusion of death proceeds under IRC Section 101. In January 1981 a policyholder of E. F. Hutton LIfe Insurance Company obtained a private letter ruling granting favorable tax treatment to the entire death proceeds under a universal life insurance policy (PLR 8116073). The ruling considered the cash value (or reserve) of such a policy to be conceptually equivalent to the cash value (or reserve) of the more traditional whole life policy. Consequently it deemed the entire policy to be one of life insurance and eligible for the Section 101 exclusion.

In mid-1982, the Internal Revenue Service evidenced second thoughts about the ruling that it had issued respecting the Hutton Life policy. Tax Counsel for Hutton Life was called in for further discussions and a General Counsel's memorandum was written by the Internal Revenue Service (GCM 38934, dated July 2, 1982; released in December, 1982). This memorandum asserted that a universal life policy should be divided between its risk element and its cash value element and only the risk element excluded under Section 101.

In mid-1982 the Congress was considering TEFRA and provisions providing temporary rules for the taxation of life insurance companies. With the concurrence of Tax Legislative Counsel staff of the Treasury Department, provisions relating to universal life policies were included in TEFRA, nullifying the effect of GCM 38934 and prescribing rules under which universal life policies could qualify for the Section 101 exclusion of death proceeds.

II. TEFRA PROVISIONS RE UNIVERSAL LIFE POLICIES

Prior to 1982 my company advocated the establishment of guidelines under which death proceeds of universal life policies could qualify for the Section 101 exclusion. We did so because we felt that a product as consumer oriented as universal life should not be excluded from the marketplace simply because the Internal Revenue Service created uncertainty by delaying its consideration of the issue. We felt that guidelines would establish a basis upon which the Internal Revenue Service should issue a favorable ruling.

Tax Legislative Counsel for the Treasury Department appears to have agreed with us. They viewed universal life insurance in the broader context of considering what tax treatment is appropriate for annuities and life insurance products in a marketplace where banks, mutual funds and securities dealers also compete with insurance companies. In June 1982 we discussed with them our perception of the need for guidelines and prepared draft legislation for their review and critical comment. Having received their input, we sought and obtained endorsement of the guidelines by the American Council of Life Insurance (the principal life insurance industry association). Thereafter, universal life guidelines were included in discussions with Senate and Joint Committee staffs and bill sponsors which eventually resulted in inclusion in TEFRA of flexible premium life insurance contract guidelines (Section 266 of TEFRA).

These guidelines are unavoidably complex. Stated in their simplest form, they provide two alternative tests for determining when a flexible premium contract contains a sufficiently large risk element to justify exclusion of death proceeds under Section 101. The term "flexible premium life insurance contract" is defined in the statute (IRC § 101(f)(3)(A)). It includes not only universal life policies, but also "adjustable life" policies offered by several mutual life insurance companies. For convenience of indentification, these two tests will be called the "cumulative premium test" and the "cash value" test.

The cumulative premium test has two elements. First, the maximum cumulative premium permitted is calculated. Second, the percentage by which the face value of the policy must exceed its cash value is prescribed. The maximum cumulative premium element permits the insurer to design the policy so that the policyholder can be assured that the entire death proceeds of the policy will be free of income tax at death. Detailed rules are contained in the statute to make certain that no amount of manipulation in policy design or operation can frustrate or avoid the intent of the limiting test. The percentage of risk coverage required (sometimes called the "corridor" requirement) insures that a significant amount of risk coverage remains present at all ages. This part of the test is designed to distinguish these policies quite clearly from investment vehicles and is in some ways more stringent than the relationship between face value and cash value found in a traditional whole life policy.

This "corridor" requirement provides that, at attained ages forty and younger, the face value of the policy must be at least 140 percent of the cash value of the policy. For every year over age 40 this required percentage reduces 1 percent, until at age 75 it has reached 105 percent of the cash value. Universal life policies designed to comply with TEFRA have a corridor, which does not decrease below 105 percent for ages over 75. In a traditional whole life policy, of course, any similar requirement would have to reduce to 100 percent not later than the end of the mortality table (usually age 100).

As originally discussed by insurance company representatives in conversations with Treasury officials this requirement was proposed at 125 percent at age 40 and below. However, in discussions within the life insurance industry the percentage was raised to 140 percent, because of the concerns expressed by certain life insurance companies that would be affected competitively by sales of universal life insurance. The 125 percent level provided adequate assurance that universal life policies were indeed properly characterized as life insurance policies. At the 140 percent level this assurance is more than ample. The only purpose that can be served by those who would advocate a higher percentage, or abandonment of the cumulative premium test in favor of a cash value test, it to render universal life policies noncompetitive with traditional life policies. It is important, therefore, that the existing "corridor" be retained essentially in its present form.

The cash value test is provided because "adjustable life" policies (offered by Minnesota Mutual and Bankers Life of Iowa) fall within the definition of "flexible premium life insurance contract" but cannot meet the premium guidelines at all ages. In practice the cash value test has no application to universal life policies.

Both the cumulative premium test and the cash value test permit certain riders to be attached to a universal life policy. These include a family term rider (insurance on spouse or children), an accidental death rider, a guaranteed insurability rider, and a waiver of premium rider. Inclusion of these riders affects the calculation of the cumulative premium test. An annuity rider may also be attached to a universal life policy, but its cost cannot be used in calculating the cumulative premium test. All other riders appear to be prohibited if the section 101 exclusion is to be obtained. Prohibition of other riders is an unnecessary restriction (since traditional whole life policies are not so restricted as to riders); if nonqualifying riders are permitted to be added but are not permitted to affect the calculation of the cumulative premium test, no harm will be done, and the comparability with rules applicable to traditional whole life policies will be enhanced.

According to reports and comments by other issuers of universal life policies, the cumulative premium test is operating quite well. The only areas of difficulty of which we are aware involve: (1) downward adjustments to the policy that result in a negative "guideline premium" limitation; and (2) the desirability of permitting riders other than the riders listed above, without disqualifying the entire policy from the Section 101 exclusion.

The Conference Report accompanying TEFRA contains the following paragraph with respect to the applicability of GCM 38934:

"Also, the conference agreement clarifies that any flexible premium contract that is treated under State law as a single integrated life insurance contact and that satisfies these guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separable life insurance and annuity benefits." (P. 649, Report No. 97-760)

If the universal life guidelines prescribed by TEFRA are made permanent, it is desirable that the above quoted paragraph be included in the accompanying Committee Report. Otherwise, the existence of GCM 38934 would frustrate the intent of Congress.

TEFRA contained other provisions of relevance to universal life policies. In Section 259 of TEFRA, Section 809 of the Internal Revenue Code is amended to provide a deduction (85 percent for stock life insurance companies and 77.5 pecent for mutual life insurance companies) for dividends to policyholders. Pursuant to a widely publicized private letter ruling issued by the Internal Revenue Service to Massachusetts Mutual Life Insurance company (PLR 8236069), the Internal Revenue Service considers excess interest which is credited to universal life insurance reserves to be a dividend. Companies issuing universal life insurance policies disagree with this view because their crediting of excess interest is obligated in advance (unlike dividends) and bears no relationship to undivided surplus of the company (unlike dividends). I believe that excess interest credited by stock life insurance companies should be deductible in full, like other interest credited to reserves (cf IRC § 809(a)(2)).

It is worth noting here that the private letter ruling under which excess interest was classified as a dividend was issued to a mutual life insurance company which has consistently and publicly castigated universal life insurance. I consider the handling of their private letter ruling request by the Internal Revenue Service to have been an unwarranted abuse of the IRS ruling process. It seems to me that the applicant had no intention or desire of securing anything but a ruling denying the reserve interest deduction for excess interest credited to reserves, thereby disadvantaging its competitors. Congress should not be inclined to favor the interests of such a company. To the contrary, Congress should provide a reserve interest deduction for all excess interest that is credited to reserves by stock life insurance companies which issue universal life insurance policies. These credits are payments to the benefit of a customer, unlike policyholder dividends credited to a policyholder's account by a mutual life insurance company. Dividends from a mutual life insurance company are in part a payment to a customer and in part a payment of profits to an owner. As a consequence policyholder dividends of mutual life insurance companies should be only partially deductible (as under pre-TEFRA law), while customer payments by stock life insurance companies, including excess interest, should be fully deductible.

III. GOVERNMENT CONCERNS

We are informed that the Treasury Department supports continued application of the universal life guidelines contained in TEFRA. Except for possible minor adjustments, the Treasury Department is generally satisfied with the operation of the universal life guidelines enacted in TEFRA.

The staff at Treasury have stated some concerns about the use of products with tax deferral characteristics (like life insurance) in competition with products of financial intermediaries which have no tax deferral characteristics. This has been typified as the "level playing field". In a speech to the Association for Advanced Life Underwriting on March 1, 1983, John E. Chapoton, Assistant Secretary for Tax Policy, stated:

"In some policies, the traditional function of life insurance—protection for the beneficiaries of the policy against the premature death of the insured—is becoming a secondary factor. Yet the existing tax rules applicable to investments made through life insurance companies are markedly different from those applicable to investments made through other financial intermediaries. In most cases they are more favorable, and in many instances investments through life insurance companies are tax exempt. This distorts investment decisions and encourages the development of new life insurance products to take increasing advantage of an uneven playing field.

"Consequently, in fashioning permanent tax legislation, we should recognize the similarity of these investment-oriented life insurance policies to other investments."

I would agree in general with the "level playing field" proposition, but strongly disagree with its possible application to universal life insurance. The guidelines enacted in TEFRA provide sufficient limitations upon the investment use of universal life insurance to avoid any inequity. If anything, the competitive position of life insurance, including universal life insurance, is already disadvantaged by significantly higher levels of state taxation (premium taxes), higher federal effective tax rates in comparison to other financial intermediaries and more burdensome state regulation.

I would concede that the concerns of the Treasury may have some foundation with respect to a few, but only a few, life insurance products. These may include single premium, increasing benefit life insurance policies, retirement income policies and short term endowments.

Mr. Chapoton also expressed concern about the "expanding use of certain life insurance policies that emphasize the tax benefits arising from systematic policy loans." The "certain life insurance policies" referred to do not include universal life insurance. If Congress deems "minimum deposit" borrowing techniques to constitute an abuse, the appropriate remedy lies in amending IRC Section 264, not in changes to the Section 101 rules.

IV. RECOMMENDATIONS

Because I believe that universal life insurance is a product truly more beneficial to the consumer, in comparison to traditional life insurance products, and that the TEFRA guidelines are working well, I, first and foremost, must recommend that the Congress make the TEFRA flexible premium life insurance contract guidelines permanent. Such a decision will permit universal life insurance to continue to be sold. The Section 101 exclusion should be available to all universal life insurance policies that meet the TEFRA guidelines. Any policy that meets the premium guidelines of TEFRA is essentially like, and should be treated like, traditional life insurance.

The Treasury Department displays some interest in extending the universal life guidelines to other plans of life insurance. With only a few modifications, the cumulative premium guidelines could be applied to all policies. This area merits further discussion by Treasury and Congressional staffs with industry groups. Several industry task forces are already considering these matters.

In related areas I recommend that provisions granting full deduction for customer payments credited to reserves by stock life insurance companies (including the crediting of excess interest) be included in any formula adopted by Congress and that mutual company policyholder dividends be deductible at some percentage less than 100% so as to properly reflect the ownership element inherent in such dividends.

I am opposed to the proposal put forth by Congressman Stark. It give no recognition to the ownership element in mutual company policyholder dividends, provides no clarification with respect to the applicability of the Section 101 exclusion to universal life insurance, leaves nuclear the deductibility of excess interest, permits no offset of operating losses agains investment income and would increase resulting taxes to a level entirely out of relationship to the relative profitability of life insurance companies vis a vis other taxpayers. If the level of taxes resulting from application of the Stark proposal did not make life insurance companies insolvent or noncompetitive with other financial intermediaries, it would, at the very least, indirectly raise the tax burdens of customers of life insurance companies in an inequitable and politically unacceptable manner.

Chairman **Stark**. I have just a couple of observations. This is of some interest to the Chair. One of you has indicated to me at one point—and I think it is a fairly straightforward and honest approach—that basically many of the products that members of the panel sell would not exist if there were not in effect some form of tax sheltering.

I have a feeling, Mr. Vogel, that your explanation of the difference in annuities and investments would lead you to believe that you ought to require annuitization for life for your argument to hold water. When you are just annuitizing for 5 years after sheltering the inside buildup, it seems to me one can conclude that there is a little more interest in just getting back tax shelter buildup than there is in annuitizing for life. But the main question that I think is left unanswered is why should we allow deferred annuities a more generous set of rules than we do IRA's and Keoghs.

Mr. **Vogel**. Well, sir, first of all I may say that I do respect your background, your credentials, your educational processes, and I am glad that you are putting your mind to work on this particular problem. I don't see at all that tax shelter is a proper name for either the annuity or the universal life.

Chairman **Stark**. Or Keogh.

Mr. **Vogel**. That implies a motivation.

Chairman **Stark**. No. The motivation is to save money, and that is a motivation that the Federal Government and private enterprise share.

Mr. **Vogel**. If I wanted to take that particular frame of reference and apply it to every young American's dream to have one's own home, and takes a mortgage out for that home and gets a tax deduction on the mortgage interest, that the house is not a home but a tax shelter—I think that we should put all of that aside and address the situation, as you asked.

First of all, by putting the single-premium deferred annuity in the same connotation that you put IRA or Keogh is not quite conceptually accurate, because many IRA's have annuities as their funding device. The IRA, the Keogh plan, these are generic terms for accumulating money for your retirement, and the single-premium deferred annuity is not a generic term, it is a specific product that is being sold which can be used within that framework that you mention.

Chairman **Stark**. But it is the idea if it is not to be used as a short-term investment, and the rules were obviously designed to prohibit that. We felt that without such rules, that tax treatment was too generous. There may or may not be a perfectly acceptable answer for the differences in treatment, there are a lot of things that get decided in this world politically and not by ancient philosophers or any kind of code of ethics.

We have a depletion allowance for small independent oil producers because they have got a lot of political clout, and we all know that. Is there any reason that the panel could suggest for the difference?

Mr. **Vogel**. Yes, there is.

Chairman **Stark**. Maybe we ought to ease the treatment on IRA's and Keogh's.

Mr. **Vogel**. Yes, there is a reason, Mr. Chairman.

Chairman **Stark**. That is what I would like to hear.

Mr. **Vogel**. The reason is that the single premium annuity is bought with dollars that have already been taxed, and that when they are taken out, either at retirement or under a fixed period condition, they are taxed again partially, and they are put back into circulation.

IRA, Keogh, a corporate pension plan is a tax deduction and is not bought with after-tax dollars, and that is the reason.

Chairman **Stark**. Do you think that the present system is an adequate reflection of the difference in the type of dollars invested, or would changing it to be an empirical reflection of the tax savings, satisfy you?

Mr. **Vogel**. I am not quite sure I follow that.

Chairman STARK. You are saying that annuities are funded with after-tax dollars, and therefore should have a tax treatment that reflects the fact that they are not funded with tax deductible dollars. If we provide an equivalent amount of tax savings for investing in each then that would still be fair in your book?

Mr. VOGEL. It depends on how you make it even. It depends on if you cut half off.

Chairman STARK. Credit the exact tax brackets.

Mr. VOGEL. My own personal attitude is that given the moral tone set by our current President on self sufficiency, I can't understand why there are any limits on any private initiative to defend one's self against inflation, against being impoverished at an old age.

Consequently, personally, I think that our annuities are a major contribution toward self realization and independence.

Mr. DUNCAN. Will the Chairman yield for one question?

Chairman STARK. Certainly.

Mr. DUNCAN. Mr. Vogel and the rest of the panel, what would be the difference in a regular savings account, not the IRA or Keogh, at a savings institution set up with deferred taxes in the same way? They are not permitted to do it. They are using money in the savings account that they have paid taxes on, and when it is paid to them, if it were deferred 10 years, it would be the same or just about the same thing.

Mr. VOGEL. Yes, sir, you are quite right.

Mr. DUNCAN. But you are not permitted to do it.

Mr. VOGEL. Because a savings account is really a deferred spending account. The people put money in the bank to save for things they need in the near future. We are talking here about a plan that is very long term and has nothing to do with short-term savings, so consequently——

Mr. DUNCAN. I am saying the savings industry has tried to have long-term deferred savings accounts with taxes imposed only at the end of the term, and it is not necessarily a spending account for the estates, but they have never been successful in doing it. I would yield back since I am using the chairman's time.

Mr. PICKERING. Mr. Duncan, I wonder if I might respond partly to that question.

Mr. DUNCAN. Yes, sir.

Mr. PICKERING. One of the biggest differences in an annuity contract, of course, is that there are permanent annuity rate guarantees attached to each dollar as it is received. Those annuity rate guarantees cannot be made by a savings bank or a savings and loan association.

Mr. DUNCAN. Well, they could by contract, but they can't under present laws.

Mr. PICKERING. They cannot under State laws. Only an insurance company can issue an annuity. Keep in mind that it is possible for a person who buys an annuity to never receive any money from that annuity. If an annuitant takes an option that has no refund to it, the annuitant could lose his entire money. There aren't very many of those, of course, but it happens that I am recommending one to a brother-in-law of mine who has no dependents. He could get hit by a truck and lose his $50,000 completely. That cannot happen with anything other than an annuity. To tax something where that can happen would be a big mistake.

Mr. **Duncan**. I agree with you as far as insurance is concerned, but I can't see a great deal of difference in one financial institution doing it or another. I am not saying I am opposed to what you are doing at all, but they are both closely related. By contract, most states would not prohibit it.

Thank you, Mr. Chairman.

Chairman **Stark**. Certainly.

Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Mr. Goode, we heard in your testimony about universal life products. They cost less, and the commission is lower. What is the engine that keeps these products popular?

Mr. **Goode**. The commission was lower and what was the first factor?

Mrs. **Kennelly**. And the cost.

Mr. **Goode**. Yes. And what is the engine that keeps it going? As Allan pointed out, the mathematics of it are very much like an ordinary conventional whole life insurance policy, but indeed the charges to the policyholder for, say, commissions, particularly commissions, would be somewhat lower, and that savings is passed on to the consumer. That has been a very important, one of the several important factors of its popularity.

Mrs. **Kennelly**. It is consumer demand, then, that has made these products popular?

Mr. **Richards**. If I might respond to that, consumer demand is driven by the flexibility and the disclosure primarily.

Mrs. **Kennelly**. I am now hearing good things about these products.

Mr. **Richards**. We would love to spend all day talking about how great it is.

Mrs. **Kennelly**. There is a demand for these products.

Mr. **Richards**. A very strong demand. The fact is that we are looking at probably 15 to 20 percent of the entire life insurance market in this country this year from a standing start, actually 4 years ago in our case, but generally speaking perhaps 2 years for the bulk of the industry that is writing this.

Mrs. **Kennelly**. You are here today to say why not?

Mr. **Richards**. Exactly.

Mrs. **Kennelly**. Thank you.

Chairman **Stark**. Mr. Flippo.

Mr. **Flippo**. Thank you.

Gentlemen, I wonder if you have had an opportunity to look at the Treasury's testimony concerning the guidelines on universal life? I believe their testimony was that those guidelines should possibly be tightened up somewhat. What would be your reaction to that?

Mr. **Goode**. Yes. We are, of course, familiar with that testimony, and I would like to separate my answer into two parts. One is as respects flexible premium policies, and that would include such policies as universal life insurance, and then, second, to any other policy.

I think that the guidelines as they apply to flexible premium policies are excellent, and I have no reason to believe that Treasury disagrees with that. That is what I read into his written statement.

There are some things that need to be done to the guidelines, and I would support that, but not to apply to flexible premium policies, only to apply to other either existing or potential abusive type policies, and that is the area I think Mr. Chapoton was suggesting that we pay some attention to in those guidelines.

That is being worked on. I hope that we will have something for your committee in the near future. It will be supported I hope, it is our intention that it be supported by the Life Insurance Trade Association, the ACLI.

Mr. FLIPPO. Thank you very much, Mr. Chairman.

Chairman STARK. If you want a Federal definition of life insurance, it seems to me that you are inviting Federal regulation of your products. I just make that comment to you.

In the narrow jurisdiction that we have, we really have to address ourselves only to the taxability of the product, and not to other areas that you might have to answer to a State insurance commissioner. So if it seems we are overly concerned with that area, and not so interested in writing broad definitions of what will be accomplished as a social goal or as a retirement achievement, it is because, in the narrow confines that we must work we can only deal with income taxation and not with any kind of judgmental factors on how your product ought to stand in relationship to other products.

There has been a question that has been raised often on excess interest, and I don't mean that as a pejorative term but as an initial term to the universal life contract and policyholder dividends. How would either of you distinguish those? Are they different, the same?

Mr. RICHARDS. Essentially I refer back to the testimony of the stock information group. We feel that both excess interest and dividends should be 100 percent deductible, provided there is the appropriate allowance made for the ownership interest in a mutual company.

Chairman STARK. You would describe universal life as being participating or nonparticipating?

Mr. RICHARDS. We describe it as being nonparticipating because that is the way it is required to be described under State laws. That is quite aside from any taxes, of course.

Chairman STARK. Then if we go back to the 1959 act, or stopgap, don't you feel that the excess interest and premium adjustments should be treated just as a participating dividend?

Mr. RICHARDS. Not entirely. There is another difference, and that is that excess interest is essentially a prospective mechanism. I think a good example of the difference between——

Chairman STARK. As are policyholder dividends, aren't they?

Mr. RICHARDS. No, basically policyholder dividends are a retrospective idea based on distribution of the available surplus in a mutual company.

Chairman STARK. I see. What you are saying is you are frequently adjusting your rates for the period ahead.

Mr. **Richards**. Yes. Perhaps the best way of illustrating that, we do not operate in New York, but there are some newer regulations in the State of New York which bring out this difference very clearly.

For instance, in issuing universal life, a company operating within the State of New York may not so set its excess interest payments guaranteed for whatever period in the future that it might recoup losses from prior periods. That is not permitted.

Obviously, a dividend payment which addresses itself solely to what has happened over the last year, or whatever period, can include primarily gains but also losses as well. There is a subtle distinction there.

Chairman **Stark**. There is another subtle difference here, it occurs to me. In a normal ordinary whole life contract, you can stop paying premiums generally and use your cash value to pay out some amount of life protection for the life of the contract. But as I understand some of the universal life contracts, you could probably be in a position where you are taking tax sheltered interest earnings basically and purchasing additional protection. I think that is probably the only case where we would let somebody take, in fact, a tax sheltered savings account and purchase additional property with it, so to speak.

You can't do that with an ordinary life contract because it just isn't written to increase the amount if you stop paying, but under some of the options you could basically take a savings account, put it in effect into a universal life or variable premium product and have it at your disposal in future years.

Buy yourself more insurance, and you would really be buying it with after tax savings. There is that possibility in some of the products in your industry that have been offered.

Mr. **Richards**. Curiously enough, yes, there is that possibility, but that is precisely the same mechanism that exists with the conventional.

Chairman **Stark**. I understand that, but I don't know if it has ever, in the past, allowed you to go above the face of the contract.

Mr. **Richards**. Oh, yes.

Chairman **Stark**. If you quit paying premiums after 10 years, you usually are not able to maintain the full face amount, and I am suggesting that I don't think there have been products before where you could, each year, make a decision if you wanted to add to it; it is a fine distinction.

Maybe I misinterpret it, but it gives you a reserve savings account over here, if I can use that terminology, and you can decide in future years if you want to go out and buy some more insurance with the interest, on which you haven't paid taxes in effect.

I see a distinction in the past with inside buildup being allowed to accrue to the policyholder, but I think you may be breaking new ground.

Mr. **Vogel**. Mr. Chairman, may I comment on that point?

Chairman **Stark**. Sure.

Mr. **Vogel**. Try as hard as I will, I just don't see anything new in the insurance business, including the point that you just made. In the historical sense, in a mutual company whose policy is paid up, there were and still are dividend options which permit the dividend even after the paid up period to purchase additional paid up insurance.

Since the dividend is not taxable to the individual, the purchase of the paid up insurance is precisely equal in form to what you are now discovering in this supposedly new thing.

Chairman STARK. I quite agree.

I think there is some structural difference in universal life. People have offered it in a form that has not been offered before, and I suspect that in both of those circumstances somebody ought to pay some tax on that money. I have no quarrel with that. I just think they have got a little bit more refined and give a lot more flexibility to the customer. It has taken a different form perhaps with higher interest rates.

It occurs to me that you have described what has always been as I remember it par or nonpar dividend policies, where you always had the option of doing that with the cash value, as long as I can remember, and I think these are just some new bells and whistles using the same kinds of contracts.

Mr. VOGEL. That really is part of this overall misconception I tried to address myself to previously. Interest rates have gone up, and the effect of interest rates going up is that statutory valuation interest rates have gone up, the net result is that over the last 20 years the cost of life insurance has been going down.

It is probably the only product that you can point at in this horrendous inflationary economy of ours where you are getting something for less money than you got it 20 years ago. It has gone down substantially.

The reason why it has gone down substantially is because interest rates have gone up, and the statutory valuations which lag very slowly behind it have always gone up, and as they go up, it permits us to reflect that in our premium rate calculations, but the fact that interest rates are going up seems to almost produce an instantaneous reaction that it is more investment oriented, and we had better tax it, when the truth of the matter is——

Chairman STARK. What you mean is that the higher rates mean more income, do they not, Mr. Vogel?

Mr. VOGEL. The premium rates are lower, sir.

Chairman STARK. Higher interest rates are more income by definition, are they not?

Mr. VOGEL. Partially.

Chairman STARK. Certainly. As soon as you pay more taxes——

Mr. VOGEL. Excuse me.

Chairman STARK. The more income you make, the more taxes you pay.

Mr. VOGEL. I tell you when you get higher income because interest rates are higher, you are getting lower premium income.

Chairman STARK. That is a decision the company makes, if it is to their advantage because they shelter half of their underwriting income. Smart people, like you, figured that out long before we did. That is why we are not collecting the taxes we ought to collect.

I want to thank the panel for their contribution. I know they have some special and unique problems in the code, and I assure you that the committee wants to deal with them as fairly as we do with all segments of the industry. We appreciate your working with us. Many of you I have met with privately; as we begin to hammer out a bill in the weeks ahead, we will continue to work with you and look forward to your input. Thank you very much.

I would like to call the final panel: Mr. Ted D. Lewis, legal counsel, Beneficial Life Insurance Co. of Salt Lake City; Mr. Arthur O. Dummer, member, board of directors, Continental Western Life Insurance Co., National Western Life Insurance Co., and California Life Insurance Co.; Thomas M. Dabbs, CLU, CFC, Dabbs Life Insurance Agency, Sumter, S.C.; Jeffrey M. Verdon of Newport Beach, Calif.; and Dr. Thomas G. Kabele, Ph. D., FSA, corporate actuary, the Guardian Life Insurance Co. of America, New York City.

Gentlemen, we may get called away here for a vote. It seems that we are approaching that time over on the floor.

I would like to have you proceed. We have your prepared statements and they will appear in the record in their entirety. If you summarize them, it would be fine. We will start in order.

Ted Lewis, you are the first one on the list. Will you proceed?

STATEMENT OF TED D. LEWIS, LEGAL COUNSEL, BENEFICIAL LIFE INSURANCE CO., SALT LAKE CITY, UTAH

Mr. LEWIS. Thank you, Mr. Chairman, members of the subcommittee.

My name is Ted Lewis. I am legal counsel for Beneficial Life Insurance Co.

I would like to thank you for the opportunity to testify here today and to commend you for your efforts, not only in these lengthy and grueling hearings, but also in your preparation to make this meaningful.

As a member of the life insurance industry, I am impressed you have gone to so much work.

I addressed my written testimony to two narrow points. Because one of them, which dealt with policyholder taxation, has been covered at some length, I won't make any comments about that now. That can stand by itself.

I would like to make a few comments, however, regarding your question relative to reinsurance.

I would like to begin by saying if there were some way I could wash away all of the negative connotations that have developed because of the extensive discussions surrounding the repeal of section 820, I would love to do that.

That is probably not possible, but by mentioning it, maybe we start somewhere closer to zero.

The value of reinsurance is, I think, unquestionable. I would simply make the point that it is a second tier of life insurance, health insurance, the other kinds of insurance products, and that the same risks are passed on. It is just that sometimes one contract takes care of several thousand or a portion of those, and that it is very critical that nothing in the tax policy, nothing that you look at, curtail or discourage in any way this continued function of reinsurance. I think that goes somewhat without saying.

I guess I am testifying here today because I wanted to make sure that someone mentioned that, and no one has, yet.

Chairman **Stark**. I would assure you, as far as I know, nobody has ever questioned the valid function of reinsurance as it applies to taking undue concentrations of risk away from smaller companies, either as an aid to getting smaller companies started or to allow them to handle a broader range of business. Reinsurance has many valid business purposes.

It is just that there were, as we all know, some transactions which were tax-generated. Again, I make no evaluation or moral judgment on that. It was a way to pay less taxes, which was not anticipated when the 1959 act was enacted any more than interest rates above 6 percent were anticipated.

And that happens. That is why we change tax laws all the time. I don't think that we want to throw the baby out with the bath water and unduly restrict the ability of insurance companies to operate in a sound manner.

Mr. **Lewis**. I appreciate that.

Chairman **Stark**. I appreciate your calling that to our attention because we will keep it in mind.

Mr. **Lewis**. I do have a couple of points to make that would be a direct response to the question that you raised. Your question was: How can Congress be sure that continued tax avoidance doesn't occur through reinsurance transactions?

I would simply say that from the perspective of one who has been involved in those transactions, sections 255 through 257 of TEFRA—which deal with modified coinsurance transactions—pretty much take care of all of that.

In addition, section 258 of TEFRA adds a mechanism for the Treasury to get at other than arm's-length transactions between affiliated companies.

Those, plus a case-by-case policing, which is necessarily part of the system, I think are sufficient.

I would raise one item for your additional consideration. In the event that the phase system, in one form or another, is maintained, I think it would bear some examination in the area of reinsurance between companies in different phases to see if there is, in fact, any deferral that becomes permanent as a result of that.

Other than that, I think we are on course and that is all I have.

[The prepared statement follows:]

Statement of Ted D. Lewis, Legal Counsel, Beneficial Life Insurance Co.

SUMMARY

(1) Policyholders should be taxed only on amounts of income received or made available to them. Delineation should be made between traditional life insurance products and new products on the basis of forfeiture of valuable benefits. (2) Reinsurance is a valuable part of the insurance industry that needs no additional control (in terms of tax avoidance) beyond section 255 through 258 of TEFRA. Reinsurance transfers discussed.

STATEMENT

I am Ted D. Lewis, Legal Counsel for Beneficial Life Insurance Co. On behalf of Beneficial Life, I would like to direct my testimony to two specific questions contained in the April 8, 1983, press release No. 3 of the Subcommittee on Select Revenue Measures, Committee on Ways and Means. My focus on these two issues is not meant to imply that other areas are not equally important, but simply a matter of time limitation and an attempt to provide for the record testimony that may not be provided by others.

POLICYHOLDER TAXATION

Question. To what extent should various types of life insurance products continue to enjoy tax preferred treatment as compared to other savings and investment products available to individuals?

Answer. A key factor in determining whether a person should be taxed on income has long been whether the income is available to the person without forfeit of substantial rights. (See e.g., Theodore Cohen, 39 T.C. 1055 (1963).) It is logical that a person not have to pay taxes on income that he has not received or cannot receive without substantial penalties. That the taxes should be paid out of income which has been received or could be received is clear, for the funds to which taxes are attributable are then available for payment of such taxes.

In applying this principle to traditional life insurance products, it is readily apparent that death benefits must be forfeit if funds are withdrawn from a life insurance policy's cash value or loan value. Surrender of the entire contract is necessary to obtain all the cash surrender values of a policy. This is a substantial forfeiture. Further, if income were imputed to a person with cash surrender values in a traditional life insurance product, those persons who most need the insurance protection—those on low or fixed income, such as the poor and the elderly—could find themselves in the position of having to give up their insurance protection in order to pay income taxes.

It is suggested that the entire notion of taxing a policyholder on the so-called "inside buildup" of a traditional life insurance product (other than endowment policies) fails to recognize the true nature of the transaction. While each policy is designed to endow at age 100 of the policyholder (premiums paid plus interest accumulated less certain expenses will equal the face amount of the policy at age 100), this is not in reality what occurs. Very few policies stay in force until the policyholder reaches the age of 100; death or a surrender of the policy before age 100 occurs in almost every case. The practical effect is that there is not a one-to-one relationship between the inside buildup of the policy values and the actual death benefit paid. The policyholder does not receive cash surrender values and death benefits; he receives one or the other.

As an aside, it should be noted that cash surrender values are a result of state nonforfeiture law requirements introduced in the early part of this century. But for such laws, it is likely that policies would be quite different today. Required to provide cash surrender values, the industry has made proverbial lemonade out of a lemon by touting the availability of this feature of policies. This feature of policies has been so emphasized and refined that today hearings are being held to view the investment angle of life insurance policies.

The discussion above applies to traditional life insurance policies, but not necessarily to all newer life insurance products. There are apparently new products that do not clearly evidence the same forfeiture of death benefits when withdrawals are made from policy values. There are, however, new products of the universal life type that do involve forfeiture of death benefit where loans or full or partial withdrawals are made. Returning to the principle that income should be taxed only when it is received or readily available without forfeiture to a policyholder, leads appropriately to the notion that a line can be drawn between traditional life insurance products and some of the newer life insurance products and between various versions of the newer products. The key is whether death benefit—the raison d'etre for life insurance—is forfeit by virtue of total or partial withdrawal.

This discussion has been purposely brief, attempting to address only conceptually the issue of taxation of "inside buildup". Admittedly, much detail has been passed over, but this avoids the proverbial Serbonian Bog. The obvious conclusion suggested by this discussion is to delineate products on the basis of availability of income without forfeiture and to provide rules for taxing policyholders who do or can readily receive such income if the Congress feels that it is necessary.

TAXATION OF LIFE INSURANCE COMPANIES

Question. How can Congress continue to assure that reinsurance transactions are not used by the industry to avoid tax?

Answer. If it were possible, I would first like to remove the negative connotations associated with the mention of reinsurance which seems to prevail in many circles as a result of the deliberations regarding and subsequent repeal of section 820 of the Internal Revenue Code relating to modified coinsurance. Because reinsurance is less visible generally and, naturally, less understood as a result, it may be difficult to remove such negative connotations. In any event, I wish to present briefly in this discussion some comments about tax avoidance through reinsurance and the value of reinsurance from a reinsurer's point of view. (I understand that other testimony will present a reinsured's point of view.)

To put my comments about reinsurance in perspective, it is necessary to view the use of reinsurance by a reinsurer. These comments apply particularly to smaller companies such as the one I represent.

Reinsurance is a vehicle that allows the type of risk and the location of risk to be diversified. The type of risk a reinsurer holds as a result of reinsurance agreements can be varied by reinsuring risks under substantially different policies than those otherwise held or written by the reinsurer.

The risks associated with a life insurance contract—namely, risks of mortality, persistency, investment and expense—can be separately reinsured. Various reinsurance agreements can be (and regularly are) designed to insure any one or more of these risks. So long as one or more of these risks are transferred, a business purpose is served, and such transfer of risk through reinsurance should not be curtailed or discouraged through Federal income tax law.

The geographic location of the risk can also be diversified. Thus, no local calamity will unduly strain a reinsurer or an insurer. To a degree this is the same protection afforded a reinsured, but is equally necessary to a reinsurer.

There are economies of scale that can be availed of through reinsurance. A company can insure risks by writing 1,000 individual policies on a direct basis, or it can insure those same risks (or some portion of them) by one reinsurance agreement.

Because of such economies of scale, a company can grow rapidly through the use of reinsurance. In addition, such growth can be timed to coincide with a company's ability to grow. It is very important to smaller companies to be able to grow in this fashion, and equally important that the tax treatment for this kind of growth be maintained on the current basis.

As to the tax avoidance question, I am unaware of any provisions of Subchapter "L" of the Internal Revenue Code that would permit the tax avoidance which resulted in the repeal of section 820. Sections 255 through 257 of TEFRA address issues that should allay congressional concerns about revenue under section 820 and section 258 allowing reallocation of income in reinsurance agreements between related parties. This leaves room only for arm's-length agreements. Case-by-case policing by the Internal Revenue Service is all that is necessary after TEFRA.

It should be noted that a reinsured must include in its income tax calculations all amounts which are transferred to a reinsurer as reserves for the contracts reinsured. The reinsurer then takes a deduction for the reserves transferred to it by the reinsured. There is thus a wash as far as deductions and income are concerned. The effect of reinsurance transactions between companies in different tax situations should perhaps be examined to determine whether legitimate deferrals are transformed to permanent tax savings.

Given the value of reinsurance (and its critical role as part of the insurance industry) to the economy and to the economic security of individuals, it is important that it be retained and fostered as at present. Little, if any, further legislative action by Congress appears to be necessary at this time.

Chairman **STARK**. Thank you very much.

The next in order in submitting prepared testimony in advance, I believe was Mr. Kabele. We will take Mr. Kabele next, then we will follow with Mr. Dummer and Mr. Dabbs.

STATEMENT OF THOMAS G. KABELE, PH.D., F.S.A., CORPORATE ACTUARY, THE GUARDIAN LIFE INSURANCE CO. OF AMERICA

Mr. **KABELE**. Thank you, Mr. Chairman.

Mr. Chairman, Guardian Life, a mutual company, supports the Mutual Company Group position. We also support the approach of the Honorable John Chapoton and the Honorable Dan Marriott and yourself to focus directly on the problems of the inside buildup and on the ownership differentiation.

The 1959 act does not focus directly on these problems. Some stocks have claimed they want to go back to the 1959 act, but I have noticed that they made at least 10 changes in the 1959 law.

For example, more specials, for stocks only, 100 percent dividend deduction, stocks only, they get bottom line consolidation, while we get the original 1959 act for ourselves and our subsidiaries.

The 1959 act originally had no special deductions and no dividend deductions for two negative companies. The Internal Revenue Service felt that phase-by-phase consolidation was more proper.

The stocks are not necessarily small companies. Of the 120 companies in the stock information group, there are only 24 controlled groups. Many of the small companies are owned by large conglomerates, which are much larger than The Guardian.

The rationale of the 1959 act is very unclear. We don't even know what it taxes. Some feel it taxes investment income, some feel it taxes gains with a variable dividend deduction, where some companies get 100 percent dividends, two negatives get zero percent dividends, and phase one will only get someplace in between, and it varies every year.

One good thing, however, about the 1959 act, it did not give stocks a differential solely because they had the word "stock" planted on their charter. In other industries, for example, such as the casualty and the savings bank industries, the mutuals have a differential, and even so the mutuals have been having a difficult time.

For example, two mutual savings and loans in California have recently decided to convert to stock companies. They couldn't make it.

They had no differential against them, but they just couldn't make it as mutuals.

It is unclear to me if the stock proposal will reach mutual casualty subjects or stocks owned by nonprofit organizations or so-called farm organizations.

We would like to talk about three, hopefully, noncontroversial issues.

The first one is the tax-exempt issue. I do not believe this is particularly a mutual stock-related issue. I have talked to a number of stock companies. They are more enthusiastic about getting the matter clarified than we are.

As a result of the proration rule, all life insurance companies pay effective taxes on tax-exempt interest and dividends. The tax is imposed by reducing our deduction for interest paid. Therefore, The Guardian, which has a lot of tax exempt securities, receives only a 30-percent interest paid deduction, whereas many other life companies receive a 46-percent interest paid deduction.

As a result, Guardian is not competitive in the group annuity market. We don't even look at it.

We do have one large group of annuity contracts, our home office pension plan. We are losing $1 million a year because of proration.

Our competitors, however, who are selling group annuities, are also hurt. They are effectively unable to buy tax exempt bonds and preferred stock because of the proration rules. The proration rules hurt States and municipalities and smokestack industries.

We believe that if we move toward an economic income base, we should get rid of the proration rule.

On short-term tax exempt securities, most of the tax benefits are going to the issuers. This was brought out in the study by the Joint Staff Group on back taxes.

On long-term tax exempt securities, the buyers are receiving some benefit for a variety of reasons. For one thing, there are risk premiums for the default risk, and the call risk.

Another reason is that right now, the casualty companies are out of the market because they have underwriting losses. We believe if companies could buy tax exempt securities, States and municipalities would pay lower interest rates.

There is another issue on capital losses on long-term bonds. I explain that in my notes.

The next issue I call the Menge rule. I don't believe the 1959 act makes any sense whatever, but it is fun to study. I love to study it. It provides jobs for actuaries.

In my testimony, I have gone over these three different Menge rules: arithmetic Menge, geometric Menge, and the two-term geometric Menge.

The two-term geometric Menge is quite close to resembling the exact evaluation. The others are inaccurate. Certainly the arbitrary menge rule does not measure the ownership portion of dividends.

My final issue is universal life. I have written a 50-page paper which I will submit to the panel. In the paper, I propose that excess interest on universal life be treated as a dividend. I refer to some old papers written by Homans and Henry Moir. These two individuals are also included in a brilliant thesis written by young University of California students on life insurance.

I have included the paper with my written testimony. I show that the universal life cash value formula can be derived from the Homans-Fackler contribution dividend formula.

There is a technical issue on universal life, which goes back to the General Accounting Office memorandum that said that universal life is term plus side fund—I believe the counsel was partly right. The dividend options on universal life appear to be the dividend accumulation option and the cash value addition option.

Neither option results in an increase in the net amount at risk. In fact, under the cash option, the amount decreases.

We believe that either the Commissioner of Internal Revenue or the Congress should clarify the issue on taxation of these dividends options. Perhaps the accumulated interest on these options should be treasted like savings accounts.

Finally, we request that the Congress not leave the issue of universal life to litigation. It would force us into a very difficult position. Both mutual companies and stock companies would be forced to make some sort of modification in their product to try to get 100 percent deduction.

While the issue is being litigated, perhaps for years, the revenue could fall off drastically, and if the companies win, the Government will get less revenue; if Treasury wins, I am not sure the companies could pay.

Now, with regard to the differential. The 7.5-percent differential is absolutely intolerable. The only thing good about it is it allows us to die slowly.

I have calculated that a 7.5-percent dividend differential is worth 40 to 60 basis points in yield credited to policyholders, which is a tremendous amount. The 22.5 percent differential is worth up to 140 to 160 basis points in yield.

We believe that if some of our policyholder dividends are to be classified as stock dividends, our premiums should be reclassified as capital contributions.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THOMAS G. KABELE, PH.D., F.S.A., CORPORATE ACTUARY, THE GUARDIAN LIFE INSURANCE CO. OF AMERICA

GENERAL POLICY ISSUES NO. 3

Are the various financial intermediaries who compete for investment and savings dollars able to do so on equal terms?

A. Description of proration rules

1. Life Insurers face larger penalties than other financial intermediaries.
2. Policyholders receive no benefit.

B. Discriminatory aspects

1. The proration rules limit insurers' investment choices.
2. The proration rules hurt state and local governments and smokestack industries..
3. Rules are different for different phases.
4. Larger conglomerates can obtain some benefit by bottom line consolidation.

C. Benefits of tax exempts go the issuers

1. On short term tax exempts most of the benefits go to the issuer.
2. Long term rates reflect risk premiums.

D. Original rationale—rebuttals

1. Two wrongs make a right.
2. Double deduction theory.

E. Capital losses on long-term bonds

TAXATION OF LIFE INSURANCE COMPANIES NO. 3

If companies are taxed under a system which segregates investment and underwriting income, what level of policyholder dividend deductions, paid out of underwriting gain, would be appropriate?

A. Investment income and underwriting income should not be segregated

1. Damage to health insurance lines.
2. Segregation not appropriate even for whole life policies.

B. Menge rule not accurate

1. Arithmetic Menge understates exact revalution.
2. Geometric Menge (10-for-1 rule) also understates exact revaluation.
3. Two-term geometric Menge suggested.

TAXATION OF LIFE INSURANCE COMPANIES NO. 7

Should deductions for excess interest and premium adjustments be subject to the same limitation applicable to policyholder dividends?

A. Universal life is really a par plan in disguise.
B. Dividend options are dividend accumulations and cash value additions.
C. Congress should not leave the issue to litigation.

0. GENERAL COMMENTS

When the 1921 tax law was being debated, Dr. T. S. Adams the Treasury Actuary told Congress that you don't have to understand the law, it is written for experts. Perhaps he meant the law was written to provide jobs for experts. The 1959 law is much more complicated than the 1921 law. To the "phase one" tax on investment income the 1959 law added "phase two negative" and "phase two positive" with special deductions, and a "phase 3" deferral. In addition many companies chartered as life companies are taxed as casualty companies.

In 1959 many experts regarded the act as a tax on "investment income" with penalty taxes for phase two positive companies, and benefits for phase two negative companies. Today many people (including the IRS) regard the tax as a tax on "gains" with a variable deduction for policyholder dividends. Phase two positive companies receive a 100 percent deduction, phase two negative companies a 0 percent deduction, and phase one companies something in between 0 percent and 100 percent.

One unnamed government official was quoted as saying the 1959 law is simply a bunch of formulas without any rationale.

Guardian Life supports the mutual company position of a simpler single phase tax based on gains with a full deduction for dividends, elimination of deferrals and "special deductions" and elimination of the approximate reserve revaluation allowed by section 818(c)(2).

We wish to discuss, however, issues which are not stock-mutual related.

1. TAX EXEMPT INTEREST AND DIVIDENDS

Current law

Under current law casualty companies receive a full exclusion for tax exempt interest. Individuals receive a full exclusion (with a few exceptions). Banks, as the result of TEFRA, are effectively taxed on a small portion of their tax exempt interest. The tax is imposed by reducing a pro rata portion of their interest paid deduction. The pro rata portion is 15 percent times the ratio of tax exempt assets to total assets.

Under current law banks and casualty companies receive the full 85 percent intercorporate dividend credit (with a 100 percent credit for subsidiaries). Savings and loans receive a full 85 percent credit, but the 40 percent bad debt deduction is then reduced. Individuals can exclude the first $100 of dividend income ($200 on a joint return), with the excess taxed.

In contrast to the above rules, life insurers are subject to very stringent rules. Tax is effectively imposed on both tax exempt interest and intercorporate dividends by reducing a pro rata portion of our "required interest." The pro rata portion equals 100 percent times the ratio of tax exempt interest and dividends to total investment income. As a result only a few life insurers buy significant amounts of tax exempt bonds and mortgages or common and preferred stocks for their general account.

Two theories

The proration rules for tax exempt interest seem to be based on two theories. The first theory is that life insurance companies are receiving benefits in other areas and therefore the proration rules restore balance. This theory seems to be based on the idea that "two wrongs make a right." We believe that two wrongs simply make two wrongs. The second theory is the double deduction theory. That is companies can deduct reserves, and a 100 percent exclusion for tax exempt would be a double deduction. This theory ignores the substantial "implicit tax" (i.e. reduced yield) on tax exempt securities.

Harm done by proration rules

The proration rules harm life insurance companies and consumers who buy life insurance because they limit our investment choices.

The "proration" rules harm state and local governments and "smokestack" industries which are denied an important source of capital. Without the "proration rules" life insurers would likely be large buyers of long-term fixed income investments such as long term tax exempt bonds and preferred stocks.

Implicit tax and risk premiums

On short term tax exempts most of the tax benefits are going to the issuer. On long term tax exempts and perpetual preferred stock buyers are receiving some tax benefits primarily for two reasons. First, there is a dearth of buyers because casualty companies are suffering underwriting losses, and because life insurers are hampered by the proration rules. Second, buyers are receiving a call premium and risk premiums for defaults and interest rate volatility.

Policyholders' share

The proration rules add back to income the so-called policyholders' share of tax exempt interest and dividends. The policyholder, however, never receives any benefit from his supposed share, either currently or at surrender or death.

Proposal

We propose that life insurance companies receive the same exclusion for tax exempt interest and intercorporate dividends as banks.

2. UNIVERSAL LIFE

Universal life is not a stock-mutual issue. Both stocks and mutuals sell universal life and both stocks and mutuals sell traditional "participating" plans.

Since universal life has already captured a significant portion of new sales, it is important for Congress to clarify the universal life situation to protect federal revenues. Leaving the situation to the courts will place the whole industry in limbo. If universal life receives a minimum 85 percent deduction with a chance to obtain 100 percent, most companies will naturally issue that product, rather than a similar par product. If the companies win in court (perhaps 10-15 years in the future) the Treasury may face a gigantic revenue loss. If the Treasury wins some companies may face bankruptcy.

Proposal

The excess interest on universal life is economically the same as a policyholder dividend. The law should be clarified to prevent any litigation on the issue. The years 1982-83 should not be grandfathered.

Dividend accumulation issue

Currently dividend accumulations are taxed as savings accounts. The "excess interest" option on type A universal life is economically the same as a dividend accumulation. Under type A equal amounts of excess interest are added to both cash values and death benefits, and there is no increase in the net amount at risk.

Proposal

We recommend that the commissioner of Internal Revenue draft regulations dealing with dividend accumulations. Either the accumulated excess interest under option A should be treated like a savings account, or else the treatment of dividend accumulations should be changed.

Cash value addition issue

The excess interest on universal life type B is added only to cash values and not death benefits. The net amount at risk is actually decreased. Arguably the accumulation of such interest should be treated like a savings account.

Proposal

We recommend that the commissioner draft regulations for excess interest on type B contracts.

Additional information

I enclose some additional material on universal life, including some pages from my paper "Universal Life and Indeterminate Premium Products and Policyholder Dividends."

3. MENGE RULE

I do not think the 1959 law makes any sense, nevertheless it is the permanent law on the books. One of the major problems with the 1959 Act is that the "arithmetic Menge" grossly understates the exact revaluation. The "geometric Menge" allowed under TEFRA also understates the exact revaluation. The problem is that reserves converge as the valuation interest rate increases. Thus 10-for-1 may be a reasonable approximation when comparing 2.5 percent with 3.5 percent reserves, but 8-for-1 is more reasonable when comparing 7 percent with 8 percent reserves, and 6-for-1 is more accurate when comparing 12 percent with 13 percent reserves. Using the original model office developed by Horace Holmes who derived the original 10-for-1 rule when comparing 3 percent with 3.5 percent reserves, I have developed a very accurate two-term geometric formula.

Proposal

I suggest that the 1959 law be permanently modified to incorporate the improved formula.

APPENDIX

1. TAX-EXEMPT INTEREST AND DIVIDENDS

Short-term tax exempts—tax benefits go to the issuers

On short term tax exempts most of the tax benefits are going to the issuers. For example, in March, 1983 short term tax exempts yields were around 4.5 percent while short term fully taxable yields were around 8.5 percent to 9 percent. Clearly, even investors in the 50 percent bracket received little benefit from investing in tax exempts. The reduced yields are a substantial "implicit tax."

Recently many companies have issued short-term "variable rate" preferred stock where the yield rate changes quarterly. In some cases the yield has been defined as the greater of the yield on 90 day, 20 year, and 30 year Treasury Securities less as much as 400 basis points. On these stocks most of the tax benefits of the 85 percent intercorporate dividend exclusion are going to the issuer.

Long-term tax exempts are not comparable with Treasuries

Buyers appear to be receiving substantial benefits from long term tax exempt investments and perpetual preferred stocks. These securities, however, are not strictly comparable with Treasuries. Many tax exempts are callable after ten years, while preferred stocks may be callable after 5 years. Treasuries may not be callable for 20-25 years. The default risk on tax exempts and preferred stock is also much higher than on Treasuries. Furthermore, the yields on Treasuries is less volatile.

Thus buyers of long term tax exempts are earning justifiable risk premiums, and the risks that are passed to the buyers benefit the issuers.

Different results in different phases

The proration rules produce different results in the different tax phases. Generally phase two negative companies receive the greatest benefit from tax exempts and phase one companies the least. Phase two positive companies receive the average of the other two phases.

Obtaining benefits of tax exempts by bottom line consolidation

The large insurance conglomerates can obtain some benefit from tax exempt investments via bottom line consolidation. Thus the upstream holding company or casualty subsidiaries invest in tax exempts. Any losses in these companies can be shared with the life companies via consolidation.

Aiding "Smokestack" Industries

Edward Jefferson, Chairman of the Du Pont Company suggested that if "smokestack" industries are "unable to generate the capital they need, I would favor special tax incentives to get them going." (See U.S. News and World Report recent issue). The proration rules, however, provide negative tax incentives to life insurance companies which might otherwise be significant investors in preferred or common stock of "smokestack industries." Because of losses "smokestack" companies may be unable to benefit from the tax deduction on bonds.

Anticompetitive nature of the proration rules

It is possible for a life insurer to obtain some benefits from tax exempts, provided that it does not sell certain products, such as group annuities. In particular, Guardian life which is one of the few life insurers which has purchased large amounts of tax exempts finds that it is locked out of the group pension market. Our deduction for interest paid is only 30 percent, versus 46 percent for some of our competitors.

Original justification for the proration rules

The proration rules for life insurance companies date back to the 1921 law. Under that law the tax rates were farily low (about 10 percent) and companies were taxed on "investment income" less a 4 percent reserve credit. (The average earnings rate was only 4.85 percent versus 8 percent-12 percent today.) E.E. Rhodes, the author of the 1921 act, felt that a deduction for tax exempt interest would be a "double deduction." As a result of the National Life case, however, companies were able to exclude all tax exempt interest.

The 1942 law imposed a tax on a portion of total investment income. Typically that portion ranged from around 15 percent to 0 percent in 1947-48. In that environment companies had little incentive to buy tax exempts.

The 1959 act imposed a "three-phase" system on life insurers. Phase one companies were taxed on investment income, phase two negative companies were taxed on gains before dividends, and phase two positive were taxed on gains after dividends with phase 3 tax deferral. In all cases investment income was taxed at full corporate rates. The Treasury came up with an ingenious method of taxing tax exempt interest, namely it just reduced other deductions.

The Supreme Court held in the *Atlas Life* Case that the 1959 rules were legal. The court developed the "burden theory." The court believed that "reserve increases" included some interest income, and that both fully taxable and tax exempt interest should bear part of the burden. Life insurers believe that the implicit tax and the additional risks in buying tax exempts and preferred stock are "burden enough."

Life insurers also have some technical problems with the court decision. Reserve increases are only timing differences. Over the life of a policy the reserve increases sum to zero, regardless of the interest rate used to discount liabilities. If reserve increases contain interest, then reserve decreases would contain negative interest, an illogical result.

In fact, life insurance companies are losing tax exempt interest permanently merely because a timing difference is computed using an interest assumption. Furthermore, the companies are subject to a double penalty. The larger the rate used to discount reserve liabilities the smaller the reserve increases and the larger the tax. Yet the larger rate produces a larger disallowance of tax exempt interest.

2A. DIVIDEND TREATMENT FOR UNIVERSAL LIFE

Current regulations

Regulation 1.811-2(a) of the Internal Revenue Code provides a very broad definition of "dividends or smaller distributions." A distribution qualifies as a dividend if it meets any one of the following three tests:

a. it is not fixed in the contract,
or b. it depends on the experience of the company,
or c. it depends on management discretion.

Regulation 1.809(a)(1)(ii) defines "return premiums" using the negative of the definition of "dividends."

Mutual company practice

In order to understand the meaning of the words experience and fixed we should study mutual company practice.

Mutual company dividends are typcially fixed in dollars and cents one calendar year in advance of the anniversary date at which they are accrued. The dividends are usually defined by the "Contribution Dividend" formula invented a century ago by Homans and Fackler, the first two presidents of the American Society of Actuaries. Various state laws and regulations require the contribution dividend formula but it is not usually printed in the contract.

Mutual companies rarely determine dividends based on the experience of the entire company or the overall profit and loss. Virtually all companies split experience by line of business. Within the individual life insurance line the larger companies determine experience based on a "class" where "class" is determined either at issue or at the time the distribution is made (see the *Rhine* v. *New York Life* Case). Small companies which do not have credible experience may use intercompany experience, especially for the mortality factor. For large group insurance cases companies may use the experience of a single group. Companies may also use the experience of a single individual in computing the policy loan interest factor.

Mutual companies use both past experience and "trends in experience" to determine dividends. For example, current dividends may be reduced to reflect prospective antiselection on settlement options or prospective declines in interest rates.

Mutual company dividends are often referred to as "return premiums" or nonguaranteed "benefits," but for tax purposes they are distinguished from return premiums of guaranteed benefits.

Mutual company dividends can be applied in several options such as (1) cash, (2) pay renewal premiums, (3) cash value additions, (4) dividend accumulations, and (5) purchasing additional insurance. For over a century mutual companies have used the "phantom premium" method of accounting for non-cash dividends. Thus the cash value of the dividend is booked in "premiums" or "considerations" and in "dividends." The accounting method had a non-tax advantage in the 1890's. Companies were ranked on their expense to premium ratios and the inflated premiums reduced the expense ratio. (See C. O. Shepherd *RAIA* 36, 1937, page 140.)

Coupons

In the early part of this century many stock companies issued guaranteed cost products which provided for the payment of "coupon pure endowments." These coupons were fixed in dollars and cents at issue, not subject to management discretion, and independent of any kind of experience. Coupons were commonly called "guaranteed dividends" or "guaranteed premium reductions." (see my paper Section B.3, page 109). For tax purposes "coupons" could be considered as either return premiums or as guaranteed benefits. The tax impact is nil. The court in *Commr.* v. *Great American Life* distinguished "coupons" from dividends. It said: "these coupons like the surrender values, fix an obligation upon the company the moment the policy is issued."

Universal life practice

By "universal life" we mean any policy which is called "non-participating" and which credits policyholders with excess interest. "Excess interest" on universal life appears to pass all three tests of a dividend (only one is necessary). Thus excess interest is determined by management discretion and is based on "prospective" experience (usually for money already invested). Also "excess interest" is not fixed in dollars and cents at issue.

The excess interest on universal life can certainly not be called a coupon or a guaranteed benefit, both of which are determined at issue, and included in reserve calculations. In fact, we do not even know what future "excess interest" will be.

Some universal life policies are "indexed," i.e. the interest is determined by Treasury bill yields. Indexed policies arguably eliminate discretion, but they appear to meet the other 2 tests. Thus the interest is not fixed in dollars and cents or by a fixed percentage at issue. Instead the pricing risk is shifted back to the policyholders. Also various states require "immunization" or "matching" of indexed products so that the index will reflect company experience. In some cases the index itself is only fixed for a period of years. Thereafter the index can be changed by management discretion.

Some universal life companies have claimed that "fixed in advance" is good enough. Mutual company dividends, however are fixed in advance and they are still dividends (for statutory purposes). Some companies claim "fixed by formula" is good enough. Congressmen Rhodes and Mills, however, were specific that fixed meant "fixed in dollars and cents or a percentage." (see my paper page 122, and Congressional Record—House, February 18, 1959, page 2574).

Importance of deciding the issue soon

According to Best's Insurance Reports Universal life now accounts for 20 percent of new sales, and only a fraction of all life companies are now selling the product. The 20 percent is up from only a couple of percent a year earlier. To preserve revenue Congress should clearly specify that excess interest is a dividend.

Dividends appear to qualify for 100 percent deduction under TEFRA

TEFRA grandfathered "excess interest" if it were "guaranteed or fixed before the period of payment of such amount begins." (Section 263(b)(1)(B)). Since dividends are fixed at year end in advance of the next anniversary in which they are credited a case could be made that the "excess interest" component of the divident is not a dividend for tax purposes. If a one-calendar year guarantee is not enough mutual companies could try a two year guarantee.

The "advance guarantee' gambit, if it works, would be even more tax efficient than the other strategies used in recent year to increase the deductibility of dividends, including

a. section 820—eliminated by sec. 255(a)
b. "dividend reimbursement"—eliminated by sec. 255(c)(2)
c. "coupon updates"—not eliminated but a doubtful practice.
d. "reinsurance tranformation" i.e. turning "life insurance" and "annuity" reserves into "casualty" reserve—not eliminated but a doubtful practice.

Summary of my paper

In my paper on "Universal Life and Indeterminate Premium Products and Policyholder Dividends." arguments that excess interest is not a dividend are rebutted, and arguments that it is a dividend are advanced. The paper also challenges alternative treatment of excess interest such as interest paid, part of assumed interest, or a direct reserve increase. I also argue that excess interest on indexed products be treated as a dividend for tax purposes. In an appendix, I show that the cash value formulas for universal life can be derived by the "contribution dividend formula" used by most U.S. mutual companies for over a century.

APPENDIX A

SINGLE DIVIDEND OPTION POLICIES

Dividend Option	General Account	Separate Account*
1. Cash		
2. Premium reduction	Indeterminate premium	
3. Cash-value addition†	Universal life type B	Universal variable
4. Accumulations‡	Universal life type A Deferred annuities	Universal variable
5. Additional insurance		
a) Paid-up additions	Indeterminate benefit	Equitable design
b) Premium-paying additions		New York Life design
c) One-year term	Indeterminate benefit	

* Additions under variable life can be both positive and negative and, therefore, are not really dividends.

† For cash-value additions, the dividend is added only to cash values and not to death benefits.

‡ For dividend accumulations, the cash values and death benefits increase by the same amount.

APPENDIX B

THE UNIVERSAL LIFE RESERVE EQUATION DERIVED FROM THE CONTRIBUTION DIVIDEND FORMULA

Let ${}_te'$, ${}_tq'$, and ${}_ti'$ be the current rates of expense, mortality, and interest. Let ${}_tR$ be the policy "fund," G the gross premium, and ${}_tDB$ the guaranteed death benefit. Then the Homans-Fackler contribution dividend-fund formula is

$$ {}_t div = ({}_{t-1}R + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR) - {}_tR \,, \qquad \text{(B1)} $$

where $t = 1, 2, \ldots, m$. (See *JIA*, XI [1863], 123, and *RAIA*, XI [1922], 119.) The formula for the dividend accumulation liability ${}_tW$, is

$$ \begin{aligned} {}_tW &= 0, && t = 0 \\ &= {}_{t-1}W\,(1 + i') + {}_t div, && t = 1, 2, \ldots, m \,. \end{aligned} \qquad \text{(B2)} $$

Define ${}_tV$ to be the total fund:

$$ {}_tV = {}_tW + {}_tR, \quad t = 0, 1, 2, \ldots, m \,. \qquad \text{(B3)} $$

Then

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR) \,. \qquad \text{(B4)} $$

If ${}_tDB = face + {}_tR$, we derive the universal life type A formula:

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'(face) \,. \qquad \text{(B5)} $$

The cash value of additions (under the policy improvement option) is forfeited on death. Thus the liability is given by

$$ \begin{aligned} {}_tW &= 0, & t &= 0 \\ &= {}_{t-1}W(1 + i') + {}_tdiv + {}_tq'{}_tW, & t &= 1, 2, \ldots, m \,. \end{aligned} \qquad \text{(B6)} $$

Then the universal life type B formula may be derived as

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR - {}_tW) \,. \qquad \text{(B7)} $$

Note that equation (B1) did not even assume that ${}_tR$ was a reserve. Actually, ${}_tR$ can be almost anything, even a straight line from zero to the maturity value. If ${}_tR$ satisfies the "equation of equilibrium"

$$ {}_tR = ({}_{t-1}R + P - {}_te)(1 + {}_ti) - {}_tq({}_tDB - {}_tR) \,, \qquad \text{(B8)} $$

then the source-of-earnings formula can be derived from (B1):

$$ \begin{aligned} {}_tdiv = {} & ({}_{t-1}R + P - {}_te)(i' - i) + ({}_te - {}_te')(1 + i') \\ & + ({}_tq - {}_tq')({}_tDB - {}_tR) + (G - P)(1 + i') \,. \end{aligned} \qquad \text{(B9)} $$

The source-of earnings formula is also called the three-factor formula. The fund formula, however, was the original formula; the three-factor formula was derived later.

APPENDIX C

THREE TYPES OF RESERVES

There are three types of reserves: (*a*) retrospective gross premium reserves, (*b*) net premium reserves, and (*c*) prospective gross premium reserves. All three are calculated using the basic reserves equation, which Homans called the "equation of equilibrium." In the following develop-

2B. DIVIDEND ACCUMULATION ISSUE

Current laws and rulings

The Internal Revenue Service has ruled that a fund is an "annuity reserve" if it is subject to permanent annuity purchase rates. Dividend accumulations, however, are treated like savings account and interest on the accumulation is taxed currently to policyholders.

Company practice

A whole life insurance contract provides the following basic benefits:

a. It is guaranteed renewable at guaranteed premium rates, and

b. It provides a guaranteed (level) death benefit and a guaranteed maturity value at the end of the mortality table.

The policy also provides secondary non-forfeiture and cash value benefits. If the policyholder ceases to make premium payments the company guarantes to apply all the cash value to purchase as much extended term as possible (or to purchase a reduced paid up policy). Since the end of the 19th century companies have also offered cash surrender value in lieu of the non-forfeiture value.

Companies also provide a third benefit, that is the cash value can be applied at guaranteed purchase rates to buy a settlement annuity.

Dividend Accumulations do not increase the net amount at risk. They are however, part of the policy's cash values and do contribute to the nonforfeiture and settlement benefits. Futhermore, dividend accumulations can even be borrowed.

Company practice

Under option A, equal amounts of excess interest is added to cash values and to death benefits. This is arguably a dividend accumulation. Universal life companies, however, are treating it as part of the life insurance reserve.

Mutual companies generally treat dividend accumulation liabilities as a side fund and send 1099 statements to policyholders for the interest credited. Arguably, mutual companies should treat dividend accumulations as a life reserve or as an annuity reserve.

Proposal

We propose that the Commissioner of Internal Revenue clarify the situation and treat all dividend accumulations equally.

2C. CASH VALUE ADDITIONS

Definition

A cash value addition is an additional premium beyond that necessary to fund the death benefit and maturity value guaranteed at issue. The premium increases the policy cash value, but not the death benefit; the amount at risk actually decreases. The additional premium can come from a dividend, from excess interest, or simply a "drop in."

The cash value addition can be used to "improve" a policy from say a whole life contract to a thirty year endowment, or from a 20 year term policy to an endowment at age 95 policy.

Company practice

Both stock and mutual companies appear to be treating cash value additions and an addition to a life insurance reserve.

Clarification

We recommend that the Commissioner of Internal Revenue draft rules clarifying the tax treatment of these additions with specific reference to the 1035 exchange rules.

One possibility is to separate the addition from the basic life reserve (for tax purposes), and treat the addition as an annuity reserve.

3. MORE EXACT MENGE RULE

The "Menge" 10-for-1 rule came from an offhand remark made by Horace Holmes in Transactions American Society of Actuaries 39, 1938.

Horace Holmes was studying the affect of reserve basis change on policyholder dividends and aggregate reserves. He made one interest rate comparison: American Men 3 percent vs. American Men 3.5 percent and concluded that the 0.5 percent change produced a 5 percent change in reserves.

Using Horace Holmes' original model office and more modern mortality tables we extended the comparison's with the results below:

Adjusted Reserve Rate (x)	Assumed Rate (v)	Exact Ratio	Geometric 10-for-1	Least Squares Fit Linear	Quadratic	Cubic
3%	2%	.89622	.90000	.92161	.89953	.89652
4	3	.90278	.90000	.92161	.90390	.90269
5	4	.90873	.90000	.92161	.90830	.90850
6	5	.91414	.90000	.92161	.91271	.91394
7	6	.91910	.90000	.92161	.91715	.91900
8	7	.92364	.90000	.92161	.92161	.92367
9	8	.92781	.90000	.92161	.92609	.92795
10	9	.93164	.90000	.92161	.93059	.93184
11	10	.93514	.90000	.92161	.93511	.93532
12	11	.93836	.90000	.92161	.93966	.93840
13	12	.94132	.90000	.92161	.94423	.94106

We use the least square technique we fit curves to the exact values. The curves were in the form:

$$VNP^x/VNP^v = C_1^{X-V}\ C_2^{X^2-V^2}\ C_3^{X^3-V^3}$$

where VNP^x (resp VNP^v) is the non-pension reserve computed using x(resp. v) as the valuation rate. Also X = 100 times the adjusted rate x and V = 100 times the assumed rate v.

We found:

	C_1	C_2	C_3
Linear	.921607	1	1
Quadratic	.888692	1.002427	1
Cubic	.879568	1.004109	.999925

The chart shows that even the Geometric Menge understates the exact revaluation. The Arithmetic Menge produces even larger understatements. For example, in comparing 3 percent reserves with 12 percent reserves the exact ration is .48289 while the geometric ratio is .38742 and the arithmetic ratio is 0.1. Because of the gross inaccuracies in the arithmetic Menge life insurance companies have paid billions more in tax dollars than was intended by Congress in 1959.

Chairman **Stark**. Thank you, Mr. Kabele.

Mr. Dummer, you are next on the list. Proceed, please.

STATEMENT OF ARTHUR O. DUMMER, MEMBER, BOARD OF DIRECTORS, CONTINENTAL WESTERN LIFE INSURANCE CO., NATIONAL WESTERN LIFE INSURANCE CO., CALIFORNIA LIFE INSURANCE CO., AND BENEFICIAL LIFE INSURANCE CO.

Mr. **Dummer**. Thank you, Mr. Chairman, I wish to comment on two narrow points raised in your press release, and particular subpoints in those areas.

With respect to the questions raised by the committee as to how Congress can insure continuation of prohibiting reinsurance transactions to avoid taxation, I would like to point out I think that they have done a pretty good job already, and probably not much more needs to be done.

There is a family of reinsurance transactions that takes place these days, which involves a financial transaction that perhaps some may regard as tax avoidance, which involves surplus relief to smaller companies.

I would hope that your statement that you don't want to throw the baby out with the bath water includes those kinds of surplus relief transactions, because, three of the companies that I represent here today at least were saved from ruin by those kinds of transactions.

Chairman **Stark**. I think you are quite right. That hardly seems to be a tax-generated transaction.

Mr. **Dummer**. Thank you.

The other point I would like to comment on is the question raised by the committee relative to re-evaluation, and I think perhaps the written statement I have submitted comments adequately on that.

I am just worried simply that if we change the rules, then the practices are going to change and we may be back to where we started from.

Thank you.

Chairman **Stark**. Thank you very much.

[The prepared statement follows:]

Statement of Arthur O. Dummer, National Western Life Insurance Co., California Life Insurance Co., Continental Western Life Insurance, and Beneficial Life Insurance Co.

SUMMARY

(1) From the point of view of a reinsured, there are critical reasons for reinsurance which should be fostered and maintained as at present. (2) Absent the provisions of Section 818(c), smaller life insurance may be competitively disadvantaged, since larger, well-financed companies could post higher statutory reserves and take a larger first year deduction for tax purposes.

STATEMENT

My name is Arthur O. Dummer. I serve as a Director and/or Officer of the following life insurance companies: National Western Life Insurance Company, California Life Insurance Company, Continental Western Life Insurance Company, and Beneficial Life Insurance Company. I intend to offer testimony on only two of the questions posed in the Press Release announcing these hearings. Both questions I will address relate to life insurance company taxation.

TAXATION OF LIFE INSURANCE COMPANIES

Question. How can Congress continue to assure that reinsurance transactions are not used by the industry to avoid taxation?

Answer. From the point of view of a reinsured, there are several key reasons for reinsurance. Any of these reasons are important enough that reinsurance should not be discouraged by tax policy. There is a possibility that unfavorable tax treatment might make reinsurance more difficult. Changes in addition to those already made by TEFRA do not appear to be necessary.

A smaller company reinsures portions of its insurance business for reasons including the following: (1) To limit its own exposure; (2) To write new policies as rapidly as the market demands or allows; and (3) To relieve the strain on company surplus. Limitation of exposure is usually accomplished by reinsuring any portion of a policy which exceeds a certain amount. Reinsurance agreements which reinsure all or a part of new policies being written can be structured to allow the reinsured to effect a recapture. Subject to reasonable recapture restraints, the reinsured has the flexibility necessary to control a larger amount of new busness without becoming insolvent due to heavy early expenses associated with writing the insurance. Finally, surplus relief reinsurance arrangements allows a company that has become impaired or insolvent to shift the risks and liabilities to another company. This is critical to the existence of companies in difficulty, and, I might note, is the reason that three of the four companies I represent here today are still operating. I would like to note that modified coinsurance was used by one of these companies when the Iowa Insurance Commissioner ordered the strengthening of surplus. The modified coinsurance allowed the company to reinsure business without selling stocks or bonds at a loss, which would have further weakened the company's surplus. I note this to indicate that even modified coinsurance has desirable and legitimate business use.

These uses of reinsurance are of enough importance that they should be fostered and continued as they are presently allowed. Tax avoidance, in my opinion, can be adequately contained restricted in reinsurance by the provisions of Sections 255 through 258 of TEFRA, together with continuing case by case examinations by the Internal Revenue Service. The TEFRA provisions deal with modified coinsurance, reallocation between related insurers and interest deductions in certain reinsurance arrangements. Such provisions are all that are necessary, provided the monitoring of the Internal Revenue Service continues to be effectively handled.

Question. Given the current general industry practice of currently using a preliminary term method for calculating reserves, can the provision for revaluing to net level reserves be eliminated?

Answer. The general industry practice in the 1950's prior to the enactment of Section 818(c) of the Internal Revenue Code was not the use of the preliminary term method for calculating reserves. The convergence of practice to the current preliminary term method has occurred while the provisions of 818(c) have been in effect. One might speculate and conclude that there exists a cause-effect relationship.

Elimination of Section 818(c) would allow the large, well-financed companies to gain a competitive advantage over smaller companies. This is because companies with a stronger asset position could easily post statutory reserves on the net level premium basis, thus incurring larger first-year deduction from income. Congressional concern for this potential problem was largely responsible for the enactment of Section 818(c). It would appear that the movement of the entire industry to the preliminary term reserve method in fact occurred when the competitive advantage of posting reserves on the net level method was removed.

Based on the potential for harm to small companies and what has occurred with Section 818(c) in effect, it is reasonable to extrapolate that smaller companies would be disadvantaged by the elimination of the elective provisions of Section 818(c). I urge Congress to retain the provisions of Section 818(c).

Chairman STARK. Mr. Thomas Dabbs, CLU, from Sumter, S.C., and I think representing the Dabbs Agency.

STATEMENT OF THOMAS M. DABBS, CLU, CFC, DABBS LIFE INSURANCE AGENCY, SUMTER, S.C.

Mr. Dabbs. Yes, sir, I represent myself. I am an agent, and thank you, Mr. Chairman, for the privilege of appearing before this committee. I want to read the summary that I presented to the committee.

The need for additional revenue by the Government is a problem that should be addressed by responsible citizens as well as by Members of Congress.

In our society, life insurance is very desirable as it provides family and business security as well as capital for investment.

Insurance premiums are paid with after-tax dollars which inflation has made more and more difficult to acquire.

The present tax-free accumulation of the cash values inside a life insurance contract is desirable as such earnings offset some of the cost of the insurance protection and should encourage saving by the insured.

Taxation of the inside buildup of cash values would cause many problems: The insurance industry would have the tremendous burden of providing an annual printout to each policyholder showing the tax liability he has for that year; some agency would have to establish a realistic cost for term insurance, a difficult figure for insurance companies to determine even at present; the insured will be encouraged to offset the taxable income by borrowing against his policy in order to get a tax deduction for the interest charged; an income tax liability on cash values will encourage the public to buy term insurance and forego permament protection.

In my opinion, the tax-free buildup of cash values has been abused in the following manner:

Initially, the deductibility of interest on policy loans permitted an insured in the 35 percent or higher tax bracket to make maximum loans and have a net outlay less than the cost of term insurance.

The insurance industry then developed products allowing the insured to make loans to pay the premiums, make another loan in the amount of 50 percent of the interest charged and thereby have the same cash flow that would have existed had the policy not been purchased.

Had the policy not been purchased, the insured would have had to pay income taxes on more reportable income. The net result is that the life insurance company receives money as interest, rather than the Government receiving this money as taxes. Some call this the Government pay all plan.

Currently, products are being designed so that the purchaser can recover all of his outlay at the end of the eighth year. These plans are being sold as group products, so that individual States do not have control of the interest charged on policy loans.

Generally, the charge is that of Standard and Poor's average interest rate over the part quarter on AAA bonds. Such interest is fully deductible by the owner. However, the cash value is given credit as a tax-free buildup of interest charged less three-quarters of 1 percent.

If the rate of interest on the loan is 12 percent, credit for cash value earning is 11.25 percent. The sales pitch is to encourage the owner to pay a high rate of interest which is fully deductible, but the owner gets income-tax-free buildup at a higher rate of interest. This approach has been responsible for the purchase of individual corporations of policies with annual premiums in the millions of dollars.

Bache-Prudential has had seminars for these in a high income tax bracket to show how life insurance contracts can be used as a tax shelter and can throw off income-tax-free payments.

RECOMMENDATION

The problem is not the tax-free buildup of cash value, but rather the deductibility of interest on life insurance policy loans. Denial of such interest deductions has the following merits:

A. It is a very simple procedure.

B. Congress has already denied deductibility of interest on loans made to purchase single premium life insurance contracts.

C. Congress has already considered this problem, but permitted an exception in situations where the purchaser paid four out of the first seven annual premiums.

The exception did not say 4 out of 10, 15, or 20, but the industry has operated on the theory that once a purchaser qualifies by paying four out of the first seven premiums, then interest charged on loans to pay future premiums is a deductible item.

D. It is a fair approach as the owner has income-tax-free accumulation of cash values during his lifetime and the beneficiary has tax-free receipt of the proceeds.

E. Restriction of interest deductions follows a trend which the Treasury Department is trying to develop.

F. The restriction of interest deduction on policy loans will encourage policyowners to leave cash values intact and thus create more savings for investment by the insurance companies.

At one time, life insurance companies restricted the investment of their reserves to mortgages, bonds, and some select stocks. Recently, however, their investments include outright ownership of business ventures such as shopping centers and office complexes.

Insurance companies have also entered into joint ventures with others, such as Marriott Hotels, in which the insurance company has equity in the joint project.

It would seem that income generated by such investments that build equity would be taxed in a different manner than investments made in bonds and mortgages, et cetera. When a mutual company purchases property, that property never goes through an estate; no estate tax is ever generated on such assets.

You might consider encouraging insurance companies to invest in some public type of project such as low-rent housing, water and sewer bonds, or Farmers Home Administration loans, projects now financed by Government funds.

It would seem that the income from investments made for socially desirable projects would be taxed at a lower rate than investments made for an equity position.

Thank you, Mr. Chairman.

Chairman STARK. Thank you, Mr. Dabbs. I certainly want to suggest that if you ever run for Congress in South Carolina, and get elected, I hope you will apply for a position on the Ways and Means Committee. I don't know what side of the aisle you would be on, but we could use your help.

You make several excellent points. I think the seminars for high-income tax folks to generate tax-free income opportunities that you refer to are one of the reasons that a few people can spoil it for the rest, and one of the things that this committee has to constantly look for. It is generally a small percentage using a loophole that was never intended. Then we go to a lot of effort to close it and it oftentimes inconveniences many people in the same industry who are trying to do a job in their principal line of business, which I submit in the life insurance industry is not necessarily selling a tax shelter, but, as almost every witness has said is providing protection in the event of untimely death. I think your testimony summarizes it very well.

And indeed, your suggestion of taxing or restricting the use of cash values, either limiting them for the purpose for which it can be borrowed perhaps only for college or to buy the first home, might be a form of restriction. I appreciate you taking the personal interest, time, and trouble to come all this way to testify.

It is much appreciated.

Mr. Moore.

Mr. MOORE. No questions, Mr. Chairman.

Chairman STARK. I want to thank all of you. We saved the best for last, as we always do.

In closing, I want to add a short statement here. I want to thank all the witnesses for their patience, cooperation, and sincere efforts to inform the members of this subcommittee on the difficult issues which we are facing.

We have not reached a consensus here today on what we should do, but that was not our intention. Rather, we hoped, and I think we have succeeded, to learn the nature of and reasons for the concerns that have been expressed by Treasury and various segments of the industry. In so doing, we better equip ourselves to address the issues at hand.

The subcommittee will now pursue its charge of developing a permanent structure this year. As we undertake this task in the weeks ahead, we will be working on a bipartisan basis with all the members of the subcommittee and with the Treasury to develop a structure which reflects sound tax policy.

We have heard a great deal during these hearings about the need for a policy that is fair to the various segments of the industry, stocks and mutuals, large companies and smaller ones.

The Chair plans to continue, as it has in the past, to consult with the various segments of the industry to assure that whatever structure we adopt preserves as best as possible the competitive balance that currently exists in the industry.

In the course of these hearings, it has become apparent that the task of developing a permanent structure will not be easy, but I believe it is an attainable goal.

I would not want anyone to underestimate our commitment to extending stopgap only as the last resort and only with a substantial toll charge that would impact all segments of the industry.

It is my belief that permament legislation is in the best interests of the industry and American consumer. With permanent rules and hopefully a simpler structure, this industry will be able to grow and prosper and through competition provide the American consumer with the insurance products which satisfy his needs.

Piecemeal approaches or stopgap legislation would be costly, burdensome, potentially inequitable and would only postpone necessary resolution of these difficult issues.

Once again, let me thank the members of this subcommittee and our witnesses for all of their cooperation and work over the past months.

Mr. MOORE. Mr. Chairman, I think the hearings have been very beneficial.

I also want to compliment the Chair and point out to the Chair this is one of the first hearings I have seen that went 2 days where all of the members of the subcommittee were here almost all of the time, which I think indicates the interest the subcommittee has in this subject.

Again, I think I just caution the industry that if they can't agree among themselves, we will just have to do it for them, and I think we fully intend to do that.

Chairman STARK. I look forward to working with you again.

The committee stands adjourned subject to the call of the Chair. Thank you all.

[Whereupon, at 3:30 p.m., the subcommittee adjourned, subject to the call of the Chair.]

TAX TREATMENT OF LIFE INSURANCE

THURSDAY, JULY 28, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. If our guests could find seats, we will begin the hearings.

Today, the subcommittee is conducting its second hearing on the taxation of life insurance companies and their products. The subcommittee has invited a broad range of industry representatives to testify on a proposal developed by Congressman Moore and myself. This proposal was developed after a careful review of the testimony received at our first hearings and in consultation with representatives of the major segments of the insurance industry. It required an enormous amount of work at the staff level, and I want to commend all those involved for their time, effort, and patience.

A lot of our staff has changed a lot of vacation plans for August and September to help us complete this task.

Congressman Moore and myself have spent over 40 hours in the past month with a task force, which included the minority and majority subcommittee staff, the full committee tax staff, the joint committee staff, members of the Treasury staff, and the staff from the majority and minority Senate Finance Committee.

We have held, as we moved along in this process, that any one of those groups had an effective veto, and we attempted to come to a consensus. In addition to our spending 40 hours, another approximately 50 hours, equally divided between the stocks and the mutuals, was spent with that staff consulting with technical experts from both of those segments of the industry.

I want to thank the industry and their representatives for the consideration and the patience that they have given the Chair and the members of the subcommittee in basically waiting and not inundating us with requests for special meetings, but helping us to move ahead to attempt to develop a structure which the industry can use.

I ask for your continued cooperation and assistance, and I want to make it clear that we are considering today a proposal and not a final legislative product.

We are holding this hearing to solicit reactions, criticisms, and, more importantly, specific data, and how this proposal will affect the various segments of the industry in specific represented companies and the competitive posture of the industry relative to other financial industries.

I believe this proposal represents a sound starting point for the development of a final legislative product.

It has been our hope to develop a structure which would tax the true economic income of life insurance companies in a manner that is fair and comprehensive and yet, at the same time, preserves the basic nature of the industry and its traditional products.

It is my belief that insofar as the structure is concerned, we have done this.

The proposal may need considerable refinement as we seek to strike a delicate balance between stock and mutual companies, and between large and small companies.

Your testimony today will provide this committee with the information necessary to accomplish that, I hope.

We are rapidly approaching the expiration of the stopgap provisions under which life insurance companies are currently taxed. If we are to enact legislative provisions this year, and I think we can, we will need the continued cooperation and good-faith efforts of all segments of the industry.

Expensive short-term extensions of stopgap would clearly not be in the best interests of the industry, and I urge you all to continue to work with us as we try and accomplish an alternative to that.

I ask unanimous consent that the press release announcing these hearings and the accompanying committee print be part of the record, and, without objection, they will.

[The information follows:]

98th Congress
1st Session

COMMITTEE PRINT

WMCP 98-10

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

DESCRIPTION OF LIFE INSURANCE INCOME TAX PROPOSAL

JULY 14, 1983

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1983

INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a further hearing on the Federal income tax treatment of life insurance companies and products for July 28, 1983.

This committee print contains a copy of a press release (Part I) announcing a further hearing by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means on the tax treatment of life insurance companies and their products. The print also contains a description of a proposal (Part II) that was advanced by Subcommittee Chairman Stark and Representative Moore to provide a framework for discussion of the tax treatment of life insurance products and companies at that hearing.

I. THE PRESS RELEASE

On July 14, 1983, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means issued the following press release:

FOR IMMEDIATE RELEASE
July 14, 1983

PRESS RELEASE #6
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202)225-3627

THE HONORABLE FORTNEY H. (PETE) STARK, CHAIRMAN (D., Calif.) SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS ANNOUNCES FURTHER HEARINGS ON THE TAX TREATMENT OF LIFE INSURANCE COMPANIES AND THEIR PRODUCTS

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced further hearings on the tax treatment of life insurance to be held on Thursday, July 28, 1983, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. Testimony will be received from invited witnesses only, including the Department of the Treasury and selected representatives of the life insurance industry.

The Subcommittee on Select Revenue Measures held hearings on the tax treatment of life insurance companies and their products on May 10 and 11, 1983 (see Press Release #3). Based on the testimony presented at those hearings, Representative Stark (D., Calif.) and Representative Henson Moore (R., La.) have developed a proposal for discussion which has as its goal a simplification of the present tax structure while reflecting the individual purpose and character of life insurance transactions.

In undertaking to develop a permanent structure in substitution for the 1959 Act, Mr. Stark and Mr. Moore took careful notice of the widely held view that the 1959 Act had many inadequacies that defied rational analysis. The comment of one court in interpreting the Act is typical:

> "These complex and obscure provisions bear all the earmarks of a conspiracy in restraint of understanding." Lincoln Nat. Life Ins. Co. v. United States, 582 F.2d 579 (Ct.Cl. 1978) at 583 n.1.

Mr. Stark and Mr. Moore believe that the proposal represents a method of tax treatment for the life insurance industry and their products which is both rational and consistent with economic reality.

In setting forth the proposal, Mr. Stark and Mr. Moore indicated that they believe that it represents a sound starting point for developing a final legislative product. The proposal is the result of many hours of work at the staff level, including extensive consultation with representatives from all segments of the life insurance industry. If the proposal imposes any unfair or unintended result on either a single company or segment of the life insurance industry, Mr. Stark and Mr. Moore encourage such affected taxpayers to bring these problems to the attention of the Subcommittee through the hearings or in written submissions. Specifically, it is requested that witnesses furnish information indicating the impact of this proposal on individual companies. In addition, it is requested that witnesses provide views as to the appropriate level of aggregate industry tax burden. Following the hearings and the receipt of written comments, it is Mr. Stark's intention to begin legislative consideration of the proposal and development of a bill by the Select Revenue Measures Subcommittee.

A summary of the proposal is set forth below. A detailed explanation of it may be obtained from either the Joint Committee on Taxation, Room 1015 Longworth House Office Building, Washington, D.C. 20515, (202)225-2647, the Subcommittee on Select Revenue Measures, Committee on Ways and Means, 1136 Longworth House Office Building, Washington, D.C. 20515 (202)225-9397, or Office of the Minority Counsel, Committee on Ways and Means, 1106 Longworth House Office Building, Washington, D.C. 20515 (202)225-4021.

Proposal Advanced by
Chairman Stark and Representative Moore
for Discussion at July 28, 1983 Hearings

I. Single Phase Tax Structure, Using a Stock Company Model -- Company taxable income would be computed on a total income approach, making no distinction between investment and underwriting income and expenses.

II. Treatment of Reserves -- Generally, a deduction for increases in reserves would be allowed where the reserves are the higher of minimum State law reserves or cash surrender value of the contract. With respect to annuity contracts prior to the annuity starting date, a deduction would be allowed for only the increase in the cash value of the contract; after the annuity starting date, increases and decreases in reserves will be taken into account under the general rule. Present-law treatment of accident and health insurance business would be retained.

III. Definition of Life Insurance

A. The temporary guidelines on universal life insurance contracts would be extended to all life insurance contracts, strengthened, and made permanent.

B. For contracts that fail to meet the definition at any time, the pure insurance portion of the contract would be treated as term life insurance exempt from income tax under section 101, and the cash surrender value is treated as deposit fund the income on which is currently taxable.

IV. Ownership Differential

A. The ownership differential would be determined on the basis of a return on equity and would operate as a limitation on the deductibility of policyholder dividends.

B. Equity (i.e., the excess of assets over liabilities) would be determined in a manner that basically relies on the annual statements required for State regulatory purposes, but adjustments would be made to the assets and liabilities to compute an equity measurement that more nearly reflects the measure of equity that would result from using generally accepted accounting principles (GAAP).

C. The rate of return to be used in computing the ownership differential would reflect market returns on both equity and debt.

V. Small Company Treatment -- A special deduction for small companies would be located in a single provision. The application of small company treatment would reflect both asset size and economic income, but not the length of time for which the company qualifies as a small company.

VI. Taxable Income Adjustment -- It is anticipated that this proposal would generate revenue of several hundred dollars less than the revenue estimates projected for the expiration of the temporary provisions at the time the Tax Equity and Fiscal Responsibility Act of 1982 was being considered. To achieve this result, all life insurance companies would be allowed a deduction for an amount equal to approximately 25 percent of their otherwise taxable income. This deduction would be computed on the basis of an affiliated group of life insurance companies using an 80-percent ownership test.

VII. Tax-Exempt Income -- Generally, the present rules for allocating tax-exempt income between policyholders and the company would remain.

VIII. Annuity Rules

A. Present-law rules with respect to application of the exclusion ratio after the annuity starting date and partial surrenders or cash withdrawals prior to the annuity starting date would remain unchanged.

B. Generally, the restrictions on income distributions from annuity contracts would be conformed with those applicable to distributions from IRA accouants.

IX. Policyholder Loans (Code sec. 264) -- No tax deduction would be allowed for interest paid on loans from life insurance policies to the extent the aggregate amount of such loans exceeds a certain amount.

X. Computation of Investment in the Contract -- Upon any surrender of or cash withdrawl from a life insurance policy, the aggregate premiums paid would be reduced by the cost of term insurance protection provided prior to such surrender or withdrawal in arriving at a policyholder's investment in the contract for purposes of computing the income of the contract.

XI. Consolidated Returns -- Any deduction or limitation based on the income of the company should be applied on an affiliated group basis.

XII. Definition of Life Insurance Companies -- For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees would not be treated as insurance reserves.

XIII. Reinsurance -- The present-law rules with respect to reinsurance transactions would be retained.

XIV. Stock Subs of Mutuals -- Stock life insurance subsidiaries that are 80 percent owned by mutual life insurance companies would be treated as mutual companies for tax purposes.

XV. Computation of Foreign Tax Credits -- Every company would compute its foreign tax credit limitation on the basis of the ratio between foreign source taxable income and worldwide taxable income.

XVI. Exclusion from Income of the Cost of Group Term Insurance (Code sec. 79) -- The nondiscrimination rules under section 79 (d) would be extended to retired employees and employees under discriminatory plans would be barred from using the uniform cost table.

XVII. Effective Dates and Transition Rules

A. Generally, the effective date for provisions dealing with the taxation of life insurance companies would be January 1, 1984.

B. Transitional rules would be provided for provisions affecting policyholders in order to prevent abusive situations or hardship to individual taxpayers.

C. Tax treatment of current amounts in the Phase III account of a stock company is unresolved, but several options will be considered by the Subcommittee.

Written Comments

For those who wish to file a written statement for the printed record of the hearing, twenty-five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Buidling, Washington, D.C. 20515, by close of business, July 28, 1983.

II. DESCRIPTION OF PROPOSAL

The subcommittee in its press release of July 14, 1983, announced a hearing to seek comment on the effect, on particular companies, of the specific proposal outlined below. The proposal, advanced by Chairman Stark and Representative Moore, is intended as a comprehensive rewrite of the provisions of Part 1 of Subchapter L of the Internal Revenue Code governing the tax treatment of life insurance companies and their products.

A. Company Taxation

Overview

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, a new single-phase tax structure would be provided. This structure would embody the tax rules applicable to corporations generally except that certain special rules would apply to address issues unique to the life insurance industry. The principal special rules would include (1) a deduction for additions to reserves based on the greater of any cash surrender value under a contract or the minimum reserve for the contract under State law, (2) a limitation on the deductibility of policyholder dividends designed to ensure that mutual companies are taxed at the company level on a minimum return on the equity of the company, (3) a special deduction for small life insurance companies, and (4) a generally applicable deduction which would reduce the aggregate tax burden on the life insurance industry.

Under present law, different life insurance companies may be taxed on distinctively different tax bases. As a consequence, life insurance companies may derive varying degrees of benefit from the special deductions and reserve computation rules of present law. For example, the 2-percent-of-premiums deduction for accident and health insurance and group life insurance results in no tax savings for a company taxed on investment income. A company taxed on its entire gain from operations may not receive a full benefit from the deduction because of the limitation on special deductions and the policyholder dividend deduction, while a company that is eligible for a partial deferral of underwriting income receives only half of that benefit. Under a single-phase structure all deductions would benefit companies equally except to the extent that the final tax burden is affected by the special deduction for small companies or the limitation on policyholder dividends of mutual companies.

Computation of the deduction for reserves

Life insurance companies must maintain reserves in accordance with State regulatory requirements. These State rules are designed to ensure the solvency of the companies rather than to measure economic income. In addition, companies enjoy a large margin of flexibility in computing their reserves. Under the proposal, rules would be provided governing the deduction for policyholder reserves that would more closely reflect the company's economic income and provide for uniform treatment of various companies regardless of the particular assumptions they make in computing reserves under State law.

As a general rule, a life insurance company could deduct as an addition to its life insurance reserves the increase from the prior year's tax reserves to the higher of the actual surrender value of the contract or the minimum State law reserve. For this purpose, the actual surrender value would be computed by reference to the provisions in any contract guaranteeing cash values reduced by any penalties or charges which would be imposed upon surrender. Minimum State law reserves would be defined as the reserves which would be required if the company (in computing its reserves and for contract purposes) used (1) a full preliminary term method of computing reserves, (2) the highest assumed interest rate permitted under State law, and (3) the most recent mortality table allowed under State law. The highest rate and most recent mortality table would be the highest rate and most recent table that could be used at the time the contract is issued in the State in which the contract is issued. Alternatively, the company could elect to use an interest rate and mortality table which represents the highest rate and most recent table permitted by the largest number of all States. For purposes of computing tax reserves, no revaluation of reserves from preliminary term to net level premium reserves would be permitted.

Thus, under these rules, if a company elects to maintain for State purposes a reserve that is higher than both the current liability of the company to the policyholder and the minimum reserve which the State would find to be adequate, then that excess would be treated as a voluntary reserve rather than a proper measure of liabilities. Generally, no deductions would be allowed for increases in contingency or voluntary reserves, or deficiency reserves. Likewise, no special deductions would be allowed for nonparticipating contracts, accident and health insurance contracts, or group life insurance contracts.

With respect to deferred annuity contracts, prior to the annuity starting date, the deduction for increases in reserves would be measured only as increases in the cash value of the annuity. After the annuity starting date, increases and decreases in reserves would be taken into account under the general rule. With respect to accident and health insurance contracts, unearned premiums and unpaid losses would continue to be computed as under present law.

Ownership differential (limitation on deduction for policyholder dividends)

Mutual life insurance companies are owned by their policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, returns on the policyholders' investment in the enterprise, or both. With respect to both stock and mutual companies, the proposal endeavors to allow a full deduction for amounts paid to policyholders in their capacity as customers.

In the case of mutual companies, the deduction for policyholder dividends (including excess interest and premium adjustments) would be limited so that a company level tax would be levied on that portion of the company's income which represents the earnings generated by the policyholders' investment in the company. In particular, the equity of a mutual life insurance company that is held for its policyholders in their capacity as owners would be computed on the basis of State regulatory and Federal tax information to approximate the equity of a stock life insurance company as computed under generally accepted accounting principles (GAAP). However, complex computations not otherwise required for State regulatory or Federal tax purposes would not be required. Thus, equity generally would be the excess of assets over liabilities as shown on the annual statement required under State law, except that assets would be increased by the amount of any nonadmitted financial (investment) assets and liabilities would be adjusted (1) to reflect the Federal tax computation of reserves described above, (2) to eliminate any reserve for securities valuation (net of tax effect on any mandatory securities valuation reserves), and (3) to eliminate any provision for policyholder dividends which are not apportioned or which are apportioned but would not be payable at year-end if the contract were surrendered at that time (without regard to the possible payment of termination dividends).

The company would be treated as earning, as a pre-tax return to their policyholders in their capacity as owners, a return on this equity equal to an amount determined under rules established in the tax law. Specifically, the rate of return would be set and adjusted to reflect the rate of return enjoyed by commercial enterprises generally. Initially, this rate would be set at 23 percent. An adjustment would be made for post-1982 changes in the three-year moving average of a combined average rate determined by taking into account the rate of return earned by stock life insurance companies on the tax equity defined above, the rate of return earned by the top 400 industrial corporations, and the rate on one-year Treasury bills (grossed up by the corporate tax rate).

If the taxable income of the company before policyholder dividends is less than the equity return, then that lesser amount would be subject to income tax. If, however, the taxable income before policyholder dividends exceeds the return on equity, the company would be taxed on its taxable income reduced by policyholder dividends but not below the return on equity.

Stock life insurance subsidiaries of mutual companies

Stock life insurance subsidiaries that are 80 percent owned by mutual life insurance companies would be treated as mutual companies for tax purposes. The limitation on policyholder dividends would be applied to stock subsidiaries according to the following rules:

1. In the case of a mutual parent and a stock subsidiary filing separate returns, the limitation on policyholder dividends would be applied to members of a mutual company's affiliated group separately; the mutual parent's stock ownership

in a subsidiary filing a separate return would not be included in the computation of the parent's equity base.

2. In the case of consolidated returns, the ownership differential provision would be applied to the members of an affiliated group filing a consolidated return on a aggregate basis. In application, the aggregate return on equity would be allocated in the same proportion as the individual member's policyholder dividends bears to the aggregate policyholder dividends paid by the affiliated group of life insurance companies filing the consolidated return.

Treatment of small companies

Under present law, a large number of smaller life insurance companies achieve substantial reductions in their taxable income through the use of one or more special provisions such as the revaluation of preliminary term reserves and the deferral of a portion of underwriting income. The amount of the reduction in taxable income achieved through these provisions varies from company to company. There does not appear to be any relationship between the size of a company and its ultimate tax liability.

Under the proposal, small life insurance companies would reduce their taxable income by 60 percent of its first $1 million in taxable income. This deduction would phase out as taxable income increases from $1 million to $4 million. Thus, a company with $4 million or more in taxable income would not be entitled to any small company deduction. Likewise, any company with more than $500 million in assets as reported on the Annual Statement would never be allowed small company treatment.

In determining eligibility for the small company deduction and the amount of the deduction, the assets and taxable income of a company would be computed on the basis of an affiliated group including both insurance and noninsurance members using an 80-percent ownership test.

Taxable income adjustment

It is anticipated that this proposal would generate revenue of several hundred million dollars less than the revenue estimates projected for the expiration of the temporary provisions at the time the Tax Equity and Fiscal Responsibility Act of 1982 was being considered. To achieve this result, all life insurance companies would be allowed a deduction for an amount equal to approximately 25 percent of their otherwise taxable income. This deduction would be computed on the basis of an affiliated group of life insurance companies using an 80-percent ownership test.

Tax-exempt income

Under present law, interest accruing on policyholder reserves is treated as funded proportionately out of taxable and tax-exempt income. These rules allocating tax-exempt income between the policyholders and the company would be retained except that the policyholder's share would include all amounts credited or paid to policyholders.

Reinsurance

The present law rules with respect to reinsurance transactions between life insurance companies and other insurance companies (i.e., denial of an interest deduction on indebtedness incurred in connection with reinsurance agreements, and Treasury allocation authority for related party coinsurance contracts) would be retained. Similarly, the present law treatment of policyholder dividend reimbursements under reinsurance contracts (the policyholder dividends are treated as paid by the ceding company and not by the reinsurer) would be retained.

Foreign tax credit

Under present law, different life insurance companies may have to calculate the foreign tax credit limitation on different bases. A company taxed on investment income may be able to credit otherwise creditable foreign income taxes imposed on underwriting income only if it generates sufficient foreign source investment income. This situation could encourage companies to invest abroad rather than in the United States. Under this approach, every life insurance company would compute its foreign tax credit limitation on the basis of the ratio between foreign source taxable income and worldwide taxable income, i.e., the rule generally applicable to other taxpayers.

Definition of life insurance companies

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees would not be treated as insurance reserves.

B. Individual Taxation

Definition of life insurance

Present law contains temporary guidelines for flexible premium life insurance products (e.g., universal life and adjustable life) for determining whether death benefits qualify as life insurance benefits exempt from income tax. Under the proposal, the temporary guidelines would be extended to all life insurance products, strengthened, and made permanent. Thus, contracts meeting either of the following alternative tests would be treated as life insurance for tax purposes:

Alternative 1

(a) Total premiums paid for a level death benefit, at any time, may not exceed the sum of the premiums paid under a 10-pay life contract (a contract which has a minimum of ten level annual premiums), or the sum of the level premiums paid over the life of the contract, assuming that the contract matures no earlier than age 95; and

(b) The face amount of the contract must be at least 250 percent of the cash value of the contract for policyholders of age 40 or less, phasing down four percent each year until the fact amount of the contract is 110 percent of the cash value (assuming the contract matures no earlier than age 95).

Alternative 2

The cash value of the contract cannot exceed the cash value computed under a 10-pay life contract maturing at age 95 (with a general exception for reasonable single premium paid-up additions).

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (the difference between the face amount and the cash surrender value) would be treated as term life insurance exempt from income tax under section 101, and the cash surrender value would be treated as a deposit fund and income earned on the fund would be taxable currently.

Annuities

Present law provides explicit rules for the computation of income on annuity contracts and a penalty on early income distributions. Under the proposal, the rules relating to the computation of income would not be changed. With respect to investments in deferred annuities, the penalty provision on income distributions would be conformed generally to those applicable to distributions from individual retirement accounts. The present 5-percent penalty for premature distributions would not be increased. Specifically, the entire interest in a deferred annuity would have to be distributed not later than the close of the taxable year in which the policyholder reaches age 70½, or over the life of the policyholder (and spouse) or over a period not extending beyond the life expectancy of the policyholder (and spouse). Loan proceeds based on the value of the annuity contract would continue to be treated as cash withdrawals.

Generally, the penalty on premature distributions of income, which would continue at the present law level of five percent, would not apply to income distributions (1) on or after the policyholder reaches age 59½, (2) upon the death of the policyholder, (3) upon the policyholder becoming disabled, (4) if the distribution is one of a series of substantially equal periodic payments for life or for at least 10 years, or (5) from a qualified pension plan.

Policyholder loans

Under the proposal, no tax deduction would be allowed for interest paid on loans from life insurance policies to the extent the aggregate amount of such loans exceeds $50,000 for any person.

Computation of investment in the contract

Upon any surrender of or cash withdrawal from a life insurance policy, the aggregate premiums paid would be reduced by the cost of term insurance protection provided prior to such surrender or withdrawal in arriving at a policyholder's investment in the contract for purposes of computing the income of the contract. The cost of term insurance would be that computed according to a standard table specified in the statute or, if lower, the actual mortality cost stated in the contract (if any).

Group term insurance

The nondiscrimination rules under section 79(d) would be extended to retired employees and employees under discriminatory plans would be barred from using the uniform cost table.

C. Effective Dates and Transition Rules

Company taxation

Generally, the effective date for provisions dealing with the taxation of life insurance companies would be January 1, 1984. Thus, the policyholder dividend limitation would be effective for all business as of January 1, 1984. Likewise, companies would be required to revalue all reserves under the new rules for tax purposes as of January 1, 1984; any difference between the tax reserves computed under present law and the reserves computed under the new rules would be taken into account pro rata over ten years.

Individual taxation

Changes in the tax treatment of annuities would be effective on the date of enactment.

The provision for adjusting a policyholder's investment in a contract to take into account the term insurance protection received would be effective for all contracts purchased after January 1, 1984.

The definition of life insurance would be effective January 1, 1984 (January 1, 1985, in the case of certain debit insurance).

The cap affecting the deduction of interest on policyholder loans would apply to all policies but only with respect to future loans, effective immediately.

Previously deferred amounts

There is no permanent provision dealing with amounts currently in the policyholders' surplus account (phase III account) in the proposed new tax structure. Under the 1959 Act, a 50-percent deferral of underwriting gains to the policyholders' surplus account was intended to moderate fluctuations in underwriting income and to effectuate a transition from prior law. Since enactment of the 1959 Act, experience has not demonstrated the type of fluctuations in underwriting income which was of concern at the time of enactment. In addition, extended loss carryover periods generally have been provided.

The subcommittee may wish to provide rules for collecting the tax on amounts currently retained in the policyholders' surplus accounts. Several options may be considered by the subcommittee:

(1) Amounts in the policyholders' surplus account could be taken into income pro rata over some extended period of time.

(2) Losses incurred by companies could be required to be offset against amounts in the policyholders' surplus account prior to being carried back or carried forward.

(3) Amounts in the policyholders' surplus account could be taken into income pro rata as existing policies terminate.

(4) Existing amounts in the account could be subject to tax only in the same circumstances as under the 1959 Act.

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ERRATA SHEET TO SUBCOMMITTEE ON SELECT REVENUE MEASURES' COMMITTEE PRINT

DESCRIPTION OF LIFE INSURANCE TAX PROPOSAL DATE JULY 14, 1983

On page 9 insert after the second complete paragraph the following sentence:

> The 23 percent rate initially established was derived by applying the 3-factors set forth to the 3-year period prior to 1982. As indicated, it would be adjusted as described for the first year to which it would be applicable, 1984.

Chairman STARK. I would like to yield to my distinguished ranking Member, Mr. Duncan.

Mr. DUNCAN. Is it the Chair's desire to hold general hearings for the next 2 or 3 days, and then the staff work in August on the proposals?

Chairman STARK. We will hold hearings today and continue into tomorrow, if necessary.

We will probably finish the hearings today. It would be my intention to work through votes.

The Chair will, in general, leave the minute the vote is called and hope to get back so that another Member can vote, to work through lunch, and try and conclude, to give all the witnesses a chance.

We are scheduled to go into an executive session for markup on next Tuesday, I believe, at 10 o'clock, but I am not sure if that is the time.

The purpose of those sessions will be to instruct the staff or make enough decisions and provide those to the staff so they can begin drafting a more technical document than we have been using.

It is pretty tough for some of these companies to figure out income taxes from a press release. We will try to be more specific and give them a much narrower target to shoot at, and we hope to have a draft or discussion, proposed bill, ready when we return from the recess in September, at which point we will start the process over with a much more refined product.

Mr. DUNCAN. Mr. Chairman, next week, there is a great number of loose ends to vote on, and I don't think it would be prudent to try to mark up a bill next week. I think the staff could be working during the recess but some of the members that I have talked to are in agreement that we should not try to mark up a bill next week.

I am not prepared to mark up a bill next week, and I think with all of the things that we are trying to wind up on the floor, it's better to wait.

Chairman STARK. As the gentleman knows, and I thought he had concurred with me last week, that it is necessary to make some decisions to allow the staff not to waste the time of the recess.

The staff have committed, and many have changed their personal plans to be here during the month of August to attempt to make a first draft in technical language of the structure which is being presented.

I would hope that the entire subcommittee would plan to participate in that, and in directing the staff as well as members of the industry.

However, if any members or segments of the industry choose not to participate, then those of us who remain would have to give instructions to the staff so they have some direction during the recess and know which way to go.

Mr. DUNCAN. Then do you plan to come back and mark it up after the recess?

Chairman STARK. Now we have nothing to mark up. There are some decisions to be made on the structure that has been outlined.

There are 5 major provisions and 20 minor provisions. For an example, one of the principal decisions that needs to be made is, will there be a single-phase economic tax calculated or revert to the old three-phase system?

My feeling is that there would be some unanimity among the segments of the industry and upon the subcommittee that we could direct the staff to draft under that provision.

There may be some provisions about which we are undecided or there is disagreement. The staff will understand that, after our markup next week, but at this point they have been given no direction, and they need that to prepare a bill which hopefully will be introduced in September, which hearings may be held and markup will proceed.

Mr. DUNCAN. I still think we should not try to mark up a bill.

Chairman STARK. I appreciate the gentleman's concern.

Mr. Moore.

Mr. MOORE. Mr. Chairman, I would like to repeat a few brief comments that I have made to all of the company representatives that I have been able to see in the last couple of days.

What we have tried to accomplish with this proposal is what we are calling a level playing field—level between large and small companies, between mutuals and stocks, and between the life insurance industry and other kinds of industries.

I ought to make it clear there is no predisposition on my part, probably not on anybody's part on this subcommittee, to try to favor one group or another, and, therefore, when we go through this subject, we are, in fact, trying to create a level playing field.

Second, I would say—and particularly to my good friend from Tennessee, the ranking minority member of this subcommittee—what we have on the table today is just a proposal, not a bill. This is very unusual, because of the complexity of the matter. We are doing everything we know how to have the industry participate in every step of the way.

Normally, when you have a hearing like this, there is already a bill. This is the second hearing.

Mr. **Duncan**. I am not opposed to the hearing, but opposed to the markup of the bill.

Mr. **Moore**. I understand that, and I appreciate the gentleman's concern, that we proceed with caution. I share that concern.

My point is, and I want to make clear to everybody who is concerned in this matter that this is just a proposal.

We are soliciting this morning responses to this proposal so we can go through yet another round of work to produce a bill that considers all the concerns raised.

We are trying to simply give some general directions to the staff so they can begin to draft a bill that will come before the subcommittee in September for a markup.

Mr. **Duncan**. In other words, it will not be a markup next week; is that correct?

You call it one thing, and the chairman calls it another.

Mr. **Moore**. The chairman is the chairman. We will have to consider his word.

Chairman **Stark**. If the gentleman will yield, we can dance around this bush a long time—the staff—there is an alternative within the discussion of the committee, and that would be to postpone work until September.

The practical effect of that would be that the committee would then preside over the expiration of stopgap. This is not a threat, a practical matter in terms of scheduling, and I think that the committee could be quite creative in the costs, in the temporary revenue increase, that such an expiration would bring, I think unfairly, and I think it would be irresponsible as long as the time now exists.

That is one alternative.

The second alternative is to take the structure as it now exists, as principally Congressman Moore and the Chair and the staff have evolved. That would be unfair to the other members of the subcommittee who rightly would like to have some input into the initial draft of a bill that would be introduced, but if indeed there is not a quorum at a markup session, I suspect that the staff would then proceed to draft a bill under the existing structure without any change, say, as a result of today's testimony. That would be unfair to the witnesses who have spent a lot of time preparing, I think, constructive criticism of the proposal.

We have felt that the most responsible procedure would be to meet next week reviewing this proposed structure in light of the testimony received today, giving the staff as much direction as we can, so that they can produce a technically drafted document from which we can work, criticize, change and mark up in September, and to the extent that all members of the committee will continue to cooperate and work with the Chair and the staff, we feel we have the time next week to do that.

A lot of votes will be inconvenient, but this has never been a convenient career.

I would hope the gentleman will continue to be with us. He has made invaluable contributions to this process, and this is an accommodation to a staff who has spent a tremendous amount of time. I think we would lose that 4 or 5 weeks when they could do the tremendously complicated job of getting a technical document out, and I would earnestly solicit the gentleman from Tennessee's cooperation and effort.

Mr. **Duncan**. It is no reflection on anyone, and I know a lot of hard work has gone on.

I just want to be sure—have your assurance—that we are not welded in concrete. We would still have an opportunity to mark up the bill when we return in September.

Chairman **Stark**. The gentleman has my unequivocal assurance that that will be the case.

Mr. **Duncan**. I am in substantial agreement with the Chair on both sides of the bill. I just want a fair hearing, it is a very important subject and not one to be treated in haste.

Chairman **Stark**. I agree with the gentleman. Thank you.

Mr. **Moore**. The exchange between the chairman and the gentleman from Tennessee is very helpful. Maybe now everybody understands what we are talking about next week—not a final markup, as we normally have in the Ways and Means Committee—but a preliminary one.

The final one will be in September, when there is a bill and we have something to work from.

We are trying to have everybody's input in helping put together a bill to be marked up in September.

I hope the understanding has now been imparted to the companies that are here, that the staff is most interested in meeting with them throughout the month of August and into September to receive their information, hear their concerns, and consider them in putting together a bill to work from in September.

Mr. Chairman, I would like to point out that there is a great deal of concern about the aggregate amount of dollars that this bill raises. We did not go into this exercise, to raise *x* amount of dollars to bail out the deficits of the country.

Quite the contrary. This bill will produce less dollars than what the budget calls for next year.

Last, Mr. Chairman, I am thus far very appreciative of the response of all segments of the insurance industry. They appear to be working with us to make this a workable bill, and it is a very responsive way to respond.

This causes me to believe we are going to be successful in producing workable, long-term legislation for the insurance industry.

I am looking forward to the hearings, and we have done a lot of work together on this bill but we still have a long way to go before it is finished.

Chairman **Stark**. Mr. Guarini.

Mr. **Guarini**. Everybody has been working well together, and we have made remarkable headway in a very complex field. I think it is important that we do keep our momentum going. I can understand the attitude of the Chair in wanting to bring this effort to fruition.

The important thing is that we have a fair, responsible bill, and that there will be a sensitivity to the competitive edge that exists between the mutuals and the stock companies. There are a number of adjustments to be made, and I am very interested in hearing from the industry. Without any further statement, I am interested in going on with the testimony.

Chairman **Stark**. Mr. Flippo.

Mr. **Flippo**. I am just looking forward to the testimony.

Chairman **Stark**. Mr. Dorgan.

Mr. **Dorgan**. I have no statement.

Chairman **Stark**. Mr. Schulze.

Mr. **Schulze**. Mr. Chairman, I would like to say what happens next week will probably largely depend upon the testimony we receive today. I hope that the witnesses are prepared to give us substantive information which will give us some direction.

Chairman **Stark**. Thank you.

Mrs. Kennelly.

Mrs. **Kennelly**. I wish to compliment you and Mr. Moore for the extraordinary amount of energy and effort that you have put into this framework for discussion.

I think we will see that this draft shows the intellectual rigor needed to address this very complex problem. I realize this is the first step—to hear all parties' concerns.

I am concerned with one of the big issues, and that is the proper construction of the ownership differential. This is not only an issue of fairness, but will have an impact on the ability of both stock and mutual companies to compete freely in the marketplace, as does the level of taxation of the industry as a whole.

These same issues work behind the decisions of the definition of life insurance, stock subsidies of mutual companies, and what to do about the phase III and reserve overhangs.

Let me end by saying that like the other members of this subcommittee, I have certainly seen a number of people from both the stocks and the mutuals. There is one universal thought that they have, and that is their admiration for the two of you for the work you have done and the exceptional quality of this draft discussion.

Chairman **Stark**. I appreciate the gentlelady's remarks.

I would like to acknowledge the presence of our colleague from Utah, Congressman Marriott, who is the chairman of the Insurance Caucus in the Congress, and who has shown an extraordinary amount of interest in this and is sitting with us today to maintain his high level of interest, and we welcome him as an observer in these proceedings.

I would now like to call on the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, and thank you for your patience.

You may proceed.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. **Chapoton**. First, I would like to state that we are happy to have the opportunity to present our views on this proposal, and we would join in the compliments to both you and to Mr. Moore, Mr. Chairman, for the tremendous amount of work you put in on this effort.

Our staff has been available from time to time, and the committee staff has done a tremendous amount of work in attempting to develop a proposal dealing with this difficult area.

We think the basic structure of the proposal does provide a sound basis for developing a new system for taxing life insurance companies, and we support most of its principal elements.

Our major source of concern with the proposal relates to the so-called ownership differential between stock and mutual companies, and I will discuss those concerns in some detail.

The proposal also addresses several significant matters concerning the tax treatment of policyholders.

We generally support the thrust of these provisions as well.

Dealing first with the proposals, provisions relating to company taxation, it deletes the present three-phase approach to the insurance companies and would replace it with a more straightforward system. It would attempt to tax mutual companies on a measure of their total earnings rather than on a portion of their investment earnings.

Treasury strongly supports single-phase taxation of life insurance companies. Such a system would eliminate many of the arrangements that have become commonplace under the existing tax rules and that frequently have produced substantial tax benefits while lacking any significant nontax business purpose. We believe that, under the proposed system, life insurance companies would be able to concentrate on conducting their business without paying undue attention to the tax consequences of their affairs.

Dealing with the reserves, the proposal does retain the approach of present law that all life insurance companies are allowed a deduction to reflect increases in their reserve liabilities, but the proposal would amend the tax treatment of reserves in several important respects.

First, the company could not take into account a higher level of reserves and the smallest reserve required by State law. However, the cash surrender value actually made available to policyholders would be taken into account if this value exceeded the minimum State law reserve required. The smallest reserve would be computed by using the highest interest rate and most recent mortality tables permitted under State law.

In addition, since States allow reserves to be computed on a preliminary term basis, reserves would have to be computed on this basis for tax purposes, and a taxpayer that computes its reserves by use of the preliminary term method would not be permitted to revalue reserves to the net level premium level, either by the exact or the approximate methods allowed under existing law.

The use by the Stark-Moore proposal of the minimum reserves required by State regulators, we think represents a significant step in the right direction. An insurance company should not be able to increase its tax deduction by setting up its tax reserve larger than the minimum reserve.

Allowing taxpayers to take into account in excess of cash value is likely to produce a tax benefit in excess of that which is economically justified.

While we are concerned by this remaining benefit, we do support the substantial improvement in the treatment of reserves contained in the proposal now before the subcommittee.

Ownership differential, a key element to a successful shift from the current three-phase system, is a mechanism for measuring and taxing the profits of mutual life insurance companies.

Unless a fair mechanism is found, the tax law will create a competitive advantage for either the stock or mutual segment of the industry, and it is also important that the mechanism not create a competitive imbalance within the mutual segment itself.

Devising a satisfactory method of a mutual company's profit is a difficult task, since a mutual life insurance company's profits cannot be measured directly.

It stems from the fact that a mutual company's policyholders are also its creditors and owners, and thus any payment made to them may consist of three elements. It may be a price rebate to the policyholders in their role as customers, or partially interest to the policyholders in their capacity as creditors, and it may be a distribution of a return on equity in their capacity as owners of the business.

It is impossible to observe the extent to which a distribution by a mutual company represents an interest payment or price adjustment, both of which would be properly deductible expenses, and to what extent it represents a distribution of corporate profits that would not be deductible. So, given the inherent inability to measure the corporate profit of a mutual company directly, it is necessary to devise a method of approximating the corporate profit of the company.

The Stark-Moore proposal follows an approach, as we suggested in our May 10 testimony, for approximating the profit of the company. Equity under the proposal, that is, the base on which the company can expect to earn a return, is multiplied by a rate of return which attempts to reflect an appropriate return on capital.

This product, or the imputed return on equity, then forms a base below which the mutual company cannot reduce its taxable income by payment of policyholder dividends.

That is the basic structure of the Stark-Moore proposal.

Involved in this structure are several simplifying assumptions which were of necessity made as a practical and objective measure—or in arriving at a practical and objective measure—of equity.

For example, a life insurance company's equity is measured under the proposal on the basis of book value of most investment assets and liabilities.

A more accurate measure would be fair market value of assets and liabilities as well as the value of the business of a going concern. Any system based on fair market value would be quite complex, and indeed might be unworkable altogether.

We are concerned that the use of book value of assets without any adjustment to reflect appreciation or decline in value, may produce serious distortions within the mutual segment of the industry, especially with regard to investment portfolios. Some companies have portfolios which are substantially greater in value than book value, and many are the opposite, and the potential for mismeasurement of any given company's equity and its profit is large.

Another simplifying assumption reflected in the proposal is that all mutual companies will realize the same rate of return on their computed equity base. That is a basic assumption of the proposal.

Use of a single rate of return ignores any variation in profitability from one company to another among the mutuals.

If a single rate of return will be applicable to all mutual companies, it is important that this rate represent the most appropriate average rate of return on equity, and we question the proposal's use of a combined average rate based on three sources.

I won't go through the mechanism of the proposal, but we do have some concerns about how it does compute the rate.

We think that if a single rate were used, the most appropriate rate would be the rate of return on equity of those stock life insurance companies that are most comparable to mutual companies.

In this regard, we would expect that the large, so-called mature stock life insurance companies may be the most comparable to mutual life insurance companies.

Finally, if the return-on-equity approach is to be used, we believe that the mutual company's return on equity should be adjusted to reflect deductions and other tax benefits that a stock company may take into account in computing taxable income, but are not available in computing statutory gain from operation; for example, the ACRS deduction.

If it is decided that the return-on-equity approach produces unacceptable distortions, an alternative approach would be needed for taxing mutual companies, and we outline several alternative approaches in our testimony, and, Mr. Chairman, may I inquire—I see the red light going on—do you want me to continue?

Chairman STARK. Continue to the point where you begin to support the proposal.

You can skip the middle part, if you want.

Mr. CHAPOTON. I will see if that shows up, Mr. Chairman.

Several alternatives for dealing with this, the imputed return or the imputed return on equity of insurance companies, one approach would be to look at the retained earnings and take a percentage of the retained earnings of the insurance of the mutual company as an indicator of its total profits.

You would be calculating the retained earnings, dividing it by a percentage taken from either stocks or other retained earnings and dividends of stocks, or another source, and that percentage, as applied to retained earnings, would determine taxable earnings. That would have several advantages: It would focus the measure of income on the company-by-company performance without relying on artificial measure of equity, and it would be relatively simple to administer.

It also has several disadvantages. One is whether the profit retained or percentage of retained earnings could be determined with any degree of certainty, and whether it would be appropriate across mutual companies, and an important disadvantage that it would provide a substantial incentive to distribute earnings to policyholders, since each dollar of additional distribution would produce a tax deduction in excess of the amount of the distribution.

Another approach, favored by some of the mutual companies, would be to tax those companies exactly like stock companies, except that a flat percentage of policyholder dividends would not be deductible. This has some appeal because it would be a simple, well-understood tax structure, and it would be based on gross income and expenses of the individual companies. We are worried that this might create distortions. It would discriminate against companies that charge a higher level of redundant premiums and have a higher level of policyholder dividends versus those that charge a lower premium, and it would discriminate against companies to some extent according to the lines of business in which they engage. It would also be susceptible to some manipulation.

So, to conclude on this problem, we recognize that my method adopted to deal with the problem of taxing mutual insurance companies, is going to be imperfect and create some distortions among taxpayers. The trick is going to be to pick an alternative which minimizes these distortions to every extent possible.

We think that it is possible to pick a successful method, and we do look forward to working with the committee toward that end.

Chairman STARK. Would you not concur that this differential is perhaps the most controversial and difficult segment of the whole problem of the committee?

Mr. CHAPOTON. I would say that, and the percentage adjustment, the entire level of taxation.

Chairman STARK. To your knowledge, and certainly to the Chair's knowledge, there is no one approach to this differential that certainly I have heard of, and I doubt that Treasury has, that there is universal agreement as a best way.

Mr. CHAPOTON. That is clear.

Chairman STARK. Also, perhaps with the esoteric discussions that the Secretary and the Chair have had as a possibility of imputing a universal cost of life insurance at the Federal level, probably no empirical solution that will yield the same results for all segments and all sizes of the industry.

Mr. CHAPOTON. That is correct.

Chairman STARK. Which leads us to the end of that road.

At some point, some group is going to have to pick, in effect, a number, or indeed a formula.

Mr. CHAPOTON. That is correct. We have enumerated several of the principal distortions that we are concerned about, and principal problems. We are concerned about the distortions in any method you pick, and we also want to be sure that any method is not subject to gaming.

Chairman STARK. I think the Secretary is familiar with the deliberations that have gone on since February, and I would just ask if he concurs that it is the intent of the staff and the administration, and the committee, and Mr. Moore and myself, to find that factor or formula which is, as near as we can humanly determine and consistent with good tax policy. In the end we may just have to pick a number, and, quite frankly, see whether the vote is there to sustain the number, and there is no way that anybody can devise to please everyone in this room.

Mr. CHAPOTON. I think that is right. I am not yet comfortable that we have considered every last option, and we would like more time.

Chairman STARK. If there is one area of unanimity, it is that there is no one answer, and sooner or later it befalls to the task of the legislator to pick that place on the scale and say that is fair.

Mr. CHAPOTON. But we do have to make certain that the numbers do not create an imbalance among the industry. There has to be a level playing field.

Chairman STARK. Thank you for letting me interrupt.

Mr. CHAPOTON. I will be rather brief, Mr. Chairman. Let me turn to the——

Chairman STARK. Now on the rest of the issues——

Mr. CHAPOTON [continuing]. Taxable income adjustment. We stated earlier in our May 10 testimony, once you adjust tax, the life of the taxable income of life insurance companies, the application of a 46-percent corporate rate to that income or to that economic income, would cause this industry to be overtaxed relative to other financial intermediaries. We suggested then that you would have to use a reduced corporate rate or an across-the-board deduction to bring the aggregate tax burden of the industry in line.

We think that that is far preferable to the present collection of complex and inflexible and incomprehensible provisions evidently designed for that purpose.

We do support the taxable income adjustment mechanism set forth in the Stark-Moore proposal, and we believe, as I know the chairman understands, that the magnitude of the adjustment factor may have to be raised or lowered to generate the appropriate tax burden of the industry.

The 25-percent tax deduction would result in life insurance companies paying a tax of no greater than 34.5 percent, and this would be somewhat higher than the effective rate of other financial intermediaries, although I think the 34.5 percent would, in practical effect, overstate the tax burden of the industry for the reasons I set forth in the testimony.

Finally, let me turn to the taxation of individual policyholders. The most significant provision in the proposal dealing at the policyholder level is the definition of life insurance.

TEFRA started down this road. It provided a definition of life insurance which was applicable only to flexible premium life insurance. It used two alternative tests for seeing that such policies qualify as life insurance and were entitled to the tax benefits of life insurance.

The Stark-Moore proposal would use the same framework with its two alternative tests to provide a permanent definition, but the proposal would tighten some of the limitations in the current definition in an attempt to exclude certain policies which are overly investment oriented.

Mr. CHAPOTON. As with the change in the method of computing reserves, we believe that the proposed definition of insurance is an important and significant step in the right direction.

In particular, we support the provision in the proposal that the premiums cannot be paid more rapidly than they would be paid if the policy required premiums to be made in 10 equal, annual, premium payments. We also support the proposed rule that the contract may endow no earlier than age 95.

These two rules would provide some assurance that life insurance policies will not be overly investment oriented.

We go on to state, and I won't go into any detail in my presentation this morning, but we go on to point out that a good measure of the investment orientation of a life insurance contract is the ratio of the aggregate investment income to cumulative mortality and loading charges, measured at the time when a policy might be terminated. We give an example.

In the testimony, we select age 70 as the average termination date and we show an example under the TEFRA definition of life insurance and under the assumptions we set forth there.

The ratio of cumulative mortality and loading charges and investment income to mortality charges, the ratio would be 9 to 1 under the TEFRA limitation. We think that is too high a ratio under the bill.

Under the same assumptions, the ratio would be reduced by almost one-half to 4.6 to 1. We think that is a marked improvement. We even have some concerns that that may not go far enough.

A traditional whole life policy is an investment to insurance ratio which does not significantly exceed 1 to 1 at any time during the life of the policy. We think that is an area that needs to be examined further.

There are limitations on policyholder loans on the deductability of interest on policyholder loans that exceed $50,000. We generally support some type of limitations to prevent insurance policies from being used as tax shelter devices.

And then, finally, Mr. Chairman, let me point out on the effective dates in the transition rules, the most significant question that the subcommittee is going to have to face there is dealing with the change in the method of computing reserves.

The proposal would allow an insurance company to revalue its reserves. First of all, if you allow an insurance company to revalue its reserves using the new reserve method with respect to old policies, there would be a significant windfall involved.

In order to avoid this windfall, the proposal allows the new reserve method on old policies to be used but the difference in the overall level of reserves as computed under the two methods would be brought back to income over a 10-year period. There would be a 10-year spread of the two.

We think that is probably a sound approach to that problem. We generally support the effective date provisions of the policyholder taxation matters.

That will conclude my oral presentation, Mr. Chairman.

Mr. GUARINI [presiding]. Thank you very much.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee, I am happy to have this opportunity to express the views of the Treasury Department on the legislative proposal of the Chairman and Representative Moore on the taxation of life insurance companies. We believe that the basic structure of the proposal provides a sound basis for developing a new system for taxing life insurance companies and we support most of its principal elements. We also believe that such a system would be a significant improvement over the system of taxation established under the Life Insurance Company Tax Act of 1959 as well as the system of taxation that has been in effect under the "stop-gap" provisions of TEFRA that are scheduled to expire at the end of this year.

Our major source of concern with the proposal relates to the so-called "ownership differential" between stock and mutual companies. While we recognize that this is a difficult problem for which there is no perfect solution, we are concerned that the "return on equity" approach as set forth in the proposal may create unacceptable distortions in the taxation of mutual companies. We also believe that improvements can be made upon certain other aspects of the proposal.

The Stark-Moore proposal also addresses several significant matters concerning the tax treatment of policyholders. In general, these provisions represent significant improvements over the provisions of existing law. We generally support the thrust of these provisions.

We have discussed many of the issues addressed in the Stark-Moore proposal in our previous testimony before this Committee and we will occasionally make reference to that testimony.

A. COMPANY TAXATION

1. Single-phase taxation

Under the proposal, the present "three-phase" approach to the taxation of life insurance companies would be replaced by a more straightforward system based on economic income. In addition, it would attempt to tax mutual companies on a measure of their total income, rather than on a portion of their investment earnings.

Treasury strongly supports single-phase taxation of life insurance companies. Such a system would eliminate many of the arrangements that have become commonplace under the existing tax rules and that frequently have produced substantial tax benefits while lacking any significant non-tax business purpose. We believe that, under the proposed system, life insurance companies would be able to concentrate on conducting their business without paying undue attention to the tax consequences of their affairs.

The proposal would also be fairer than current law in that it would eliminate the "special" deductions and the "deferral" of tax on a portion of underwriting income. These provisions are of disproportionately high benefit to some companies while yielding no benefit at all to others.

2. Reserves

One feature of the present method of taxing life insurance comnpanies which would be retained under the proposal is that all life insurance companies would be allowed a deduction to reflect increases in their reserve liabilities. As we have discussed in our prior testimony, reserve liabilities reflect two facts. First, a portion of the premium paid on a "whole" life insurance policy may be viewed as a deposit into a savings account. Certain reserves established in connection with life insurance policies reflect the company's liability to the policyholders for this amount of savings. Second, reserves also reflect an estimate of the present value of net liabilities that the company anticipates it will incur in the future.

Under current law, an insurance company may deduct any addition to a reserve established for state regulatory purposes. In addition, a life insurance company which calcualtes its reserves on a "preliminary term" basis may compute its reserves for tax purposes by using the "net level premium" reserve method. The change in the level of reserves may be calculated by using either an exact revaluation or an approximation formula.

The proposal would amend the tax treatment of reserves in several significant respects. First, for tax purposes, a company could not take into account a higher level of reserves than the smallest reserve required by state law, so that it would be permitted a tax deduction only for increases in reserves computed on this basis. However, the cash surrender values actually made available to policyholders would be taken into account if this value exceeded the minimum reserve required. The smallest reserve required by state law would be computer by using the highest interest rate and the most recent mortality table permitted under state law. Also, since states allow reserves to be computed on a preliminary term basis, reserves would have to be computed on this basis for tax purposes. Unlike current law, the proposal would require a taxpayer who computes reserves by use of the net level premium method for state regulatory purposes to compute reserves for tax purposes by use of the preliminary term method; a taxpayer that computes its reserves by use of the preliminary term method would not be permitted to revalue reserves to the net level premium level, either by the exact or approximate method.

In general, we believe that these proposed changes would significantly improve the tax treatment of reserves. Of particular importance is the elimination of the use of the net tax premium method of computing reserves as the norm for tax purposes. As we stated in our earlier testimony before this Subcommittee, we believe that the use of the net level premium method of computing reserves for tax purposes is unduly generous, especially when combined with the right of life insurance companies to deduct acquisition costs when incurred. The distorting effect of using the net level premium reserve is especially great when the approximate revaluation formula is used since, in many cases, the formula gives an adjustment which is significantly higher than the one which would be produced by using an exact revaluation.

We feel that the proposal's use, for tax purposes, of the minimum reserves required by state regulators also represents a significant step in the right direction. An insurance company should not be able to increase its tax deductions simply by setting up a reserve larger than the minimum reserve required by the state regulators. Hence, we would oppose any change to the proposal that would allow reserves to be taken into account for tax purposes in excess of that demanded by the state regulators.

As we have previously stated, allowing taxpayers to take into account reserves on life insurance policies in excess of cash value is likely to produce a tax benefit in excess of that which is economically justified. While we are concerned by this remaining benefit, we support the substantial improvement in treatment of reserves contained in the Stark-Moore proposal.

Finally, we support the proposal's retention of the rule enacted in TEFRA that prevents life insurance companies from claiming additional deductions for amounts in the nature of interest guaranteed for future periods beyond the close of the taxable year. We believe that this rule is sensible and should be applied generally, whether the interest is expressly stated or otherwise.

3. Ownership differential

One key element to a successful shift from the current three-phase system of taxation of life insurance companies is a mechanism for measuring and taxing the profits of a mutual life insurance company. Unless a fair mechanism is found, the tax law will create a competitive advantage for either the stock or the mutual segment of the life insurance industry. Also, it is important that the mechanism not create a competitive imbalance within the mutual segment. A significant goal of this legislation should be to minimize both types of imbalances.

Devising a satisfactory measure of a mutual company's profit is a difficult task since a mutual life insurance company's profit cannot be measured directly. The measurement problem stems from the fact that a mutual company's customers (or policyholders) are also its creditors and its owners. Thus, payments made by mutual company to its policyholders may consist of up to three elements: (i) a price rebate to the policyholders in their role as customers; (ii) interest paid to the policyholders in their capacity as creditors; and (iii) a distribution of a return on equity to the policyholders in their capacity as owners of the business. It is impossible to observe the extent to which a distribution by a mutual company to a policyholder represents an interest payment or a price adjustment, which are properly deductible expenses, and to what extent it represents a distribution of corporate profits that should not be deductible.

Given the inherent inability to measure the corporate profit of a mutual company directly, it is necessary to devise a method of approximating the corporate profit of a mutual company. In our prior testimony, we suggested that one possible method of approximating this corporate profit would be to compute the capital of a mutual company and to impute a return on this capital. This suggestion was based on the notion that, in the long run, an enterprise needs to earn a competitive rate of return on its equity to remain in business. Moreover, one would expect the rates of return on equity realized by different segments of a given industry to be comparable in the long run. We believe that these observations are applicable to entities that are structured as mutual organizations as well as businesses organized as stock corporations.

The proposal follows this approach to approximating the profit of a mutual life insurance company. The "equity" in the company (*i.e.*, the base on which the company can expect to earn a return) is multiplied by a rate of return which attempts to reflect an appropriate return on capital. This product, or the imputed return on equity, then forms a tax base, below which the mutual company cannot reduce its taxable income by payment of policyholder dividends.

Several simplifying assumptions were made to incorporate into the proposal a practical and objective measure of "equity." For example, a life insurance company's equity is measured based upon book value of most investment assets and liabilities. A more accurate measure of owner equity would reflect the fair market value of assets and liabilities, as well as the value of the business as a going concern. We recognize that any system based on fair market and going-concern values for a mutual company would be extremely complex, and might possibly be unworkable. We are concerned, however, that the simplifying assumptions incorporated into the proposal may create serious distortions in the measure of taxable income of different companies within the mutual segment of the industry.

In particular, we are concerned that the use of the book value of assets, without any adjustment to reflect appreciation or decline in value, may produce serious distortions, especially with regard to investment portfolios. Some companies' portfolios may be worth substantially more than their book values while others may have portfolios with a market value less than book value. The failure to include any measure of going-concern value may create additional distortions. Thus, the potential for mismeasurement of any given company's equity, and hence its imputed profit, is large.

Another major simplifying assumption reflected in the proposal is that all mutual companies will realize the same rate of return on their computed equity base. Use of this single rate of return ignores any variations in profitability from one company to another among the mutual companies. In effect, the proposal operates as a tax on corporate surplus; for certain companies the proposal produces a fair approximation of corporate income. This concern is troubling since it will result in the overtaxation of companies whose profitability is below average and undertaxation of more highly profitable companies.

If a single rate of return will be applicable to all mutual companies, it is important that this rate represent the most appropriate average rate of return on equity. In this regard, we question the proposal's use of a combined average rate based on three sources. While the rates of return of the top 400 industrial corporations may indicate one measure of the overall corporate rate of return on equity, and the rate of return on Treasury bills would provide a measure of a minimum after-tax return on equity which an investor would expect, we believe that the use of these measures is subject to question in determining the expected rate of return on a mutual insurance company's imputed equity. Since one of the primary concerns in devising a measure of taxable income of a mutual company is to insure that neither stock nor mutual life insurance companies have a competitive advantage as a result of the tax law, a more reasonable approach would be to assume, absent any objective evidence to the contrary, that mutual companies have the same average level of pre-tax profitability as stock companies generally.

In our view, the most appropriate single rate to use is the rate of return on equity of those stock life insurance companies that are most comparable to mutual companies. In this regard, we would expect that the large so-called "mature" stock life insurance companies may be most comparable to mutual life insurance companies. For purposes of computing the return on equity realized by these stock life insurance companies, the equity of these stock companies should be determined in a manner consistent with the method used for determined in a manner consistent with the method used for determining the equity of mutual companies. This return could be adjusted to reflect the failure to tax mutual policyholders on their receipt of the equity distribution.

One reason for using the comparable stock companies' average rate of return in calculating the mutual companies' imputed return on equity is that it may lessen somewhat the distortion caused by the way equity is computed for life insurance companies under the proposal. For example, if the method chosen consistently overstated a mutual company's true equity base, and if an overstatement of comparable magnitude occurred in the measurement of the equity base of stock companies generally, the overstatement of the equity base could be offset by a corresponding understatement of the rate of return. On the other hand, since certain kinds of mismeasurement in the equity base will not occur proportionately from one segment of the industry to the other, or from company to company within a segement, these mismeasurements will produce distortions that would not be offset by the rate of return.

Finally, if the return on equity approach is to be used we believe that the mutual companies' return on equity should be adjusted to reflect deductions and other tax benefits that a stock company may take into account in computing taxable income but not statutory gain from operation. For example, to the extent stock companies benefit from ACRS and other tax incentive provisions, comparable reductions in the tax base should be made available to mutual companies.

If it is ultimately decided that the return on equity approach produces unacceptable distortions, an alternative approach for taxing mutual companies would be needed. One alternative approach would be based on the assumption that all mutual companies retain the same percentage of their profits. Based on this assumption, a retained earnings percentage would be fixed by statute and the tax base for a mutual company would be calculated by dividing its retained earnings by this percentage to obtain total taxable earnings.

This approach has several advantages. Most significantly, this proposal would focus on observable measures of income that bear some relation to company-by-company performance without relying on artificial measures of equity. It also would be relatively simple to administer. However, the approach also raises several serious concerns. First, the fundamental assumption that the same percentage of profits retained by all mutual companies is open to question. Second, it is unclear how to estimate the average percentage of earnings that will be retained by mutual companies. While the average retained earnings ratio of stock companies may serve as a starting point of analysis, the fact that stock and mutual companies have very different incentives in determining whether to retain or distribute earnings must be taken into account. Third, if a mutual company's tax base is proportional to its retained earnings, the tax system provides a substantial incentive to distribute earnings to policyholders since each additional dollar of profits distributed would produce a tax deduction in excess of one dollar.

Another alternative, favored by some mutual insurance companies, would be to tax mutual companies exactly like stock companies except that a flat percentage of policyholder dividends would not be deductible. This approach also has some appeal in that it incorporates a tax structure that is well understood by taxpayers and hence will enable them to plan their affairs with little difficulty. It also is based on the gross income and expenses of the individual companies. We are concerned, however, that this proposal would also create distortions. For example, this approach would discriminate against companies that charge a higher level of redundant premiums (and consequently have higher levels of policyholder dividends) in favor of companies that charge smaller redundant premiums (which have correspondingly fewer offsetting policyholder dividends). It could also discriminate among companies according to the lines of business in which they engage. Furthermore, this system could be susceptible to manipulation and insensitive to changes in economic conditions and trends within the life insurance industry.

To conclude, we recognize that any method adopted to deal with the difficult problem of taxing mutual companies will be imperfect, and inevitably will create some distortions among taxpayers. Evaluation of these alternatives will require an examination of which alternatives best deal with company-by-company variations. We will be happy to work with you on this difficult matter, and we expect that a satisfactory solution can be developed.

4. Stocks subsidiaries of mutual companies

The proposal would treat a stock life insurance company as a mutual company if more than 80 percent of its outstanding stock is owned by a mutual life insurance company. We believe that this feature of the proposal is appropriate and necessary to prevent mutual organizations from deriving an undue benefit by operating through one or more subsidiaries. We recognize that mutuals may form stock subsidiaries for bona fide business reasons (*e.g.*, to sell non-par insurance which a mutual company could not sell directly). We are concerned, however, that these subsidiaries could derive a substantial portion of their equity from their policyholders, and could operate in a fashion similar to that of their mutual parents. If stock subsidiaries of mutual companies were permitted to pay and deduct policyholder dividends without regard to any minimum tax base, these stock subsidiaries could gain an unfair competitive advantage over their publicly-owned stock company competitors since they would be allowed to make tax-deductible distributions of a portion of their profits to policyholders, in their capacity as equity owners. Unlike true stock companies, there would be no corporate tax except to the extent the stock subsidiary retained its earnings rather than distributing them to its policyholders in their capacity as equity owners. Accordingly, we support this aspect of the proposal.

5. Small companies

The proposal provides a special provision designed to benefit relatively small insurance companies. Under this provision, insurance companies having less than $500 million in assets and less than $1 million in taxable income would be permitted to deduct 60 percent of their taxable income (before computing the taxable income adjustment discussed below). The benefit of this deduction would be phased out ratably for taxable incomes between $1 million and $4 million.

In general, Treasury questions the need for special provisions for small life insurance companies which are not made available to small companies other than insurance companies. However, we are mindful of the fact that current law contains a number of provisions which give a significant benefit to many small life insurance companies. We support the elimination of these special provisions, both as they apply generally and as to small companies. Since the proposal would eliminate most of these provisions, the failure to include some special provision for small life insurance companies could result in a tax increase for many of these companies that some view as excessive.

In light of these considerations, we do not oppose a provision for small companies along the lines set forth in the proposal. When compared to present law, the proposal has the significant advantage of benefiting relatively small life insurance companies (*i.e.*, those with taxable income of less than $4 million) on a basis which depends only on the level of their taxable incomes. Thus, no small company will receive a disproportionately high benefit from the deduction nor will any company be denied a benefit because of the particular composition of its business.

In addition, the proposal removes the incentives in current law to engage in tax-motivated transactions, such as certain reinsurance arrangements, that have little non-tax business purposes. It also makes explicit the benefits accruing to the small companies, whereas the benefits under existing law were not explicitly stated, and in many instances were quite substantial in amount. Treasury would oppose as an alternative to the proposed small company deduction the retention of the provision which allows revaluation of reserves computed on a preliminary term basis (section 818(c)).

6. Taxable income adjustment

As we stated in our earlier testimony before this Subcommittee, the Treasury Department recognizes that the application of a 46 percent corporate tax rate to be economic income of life insurance companies could cause the life insurance industry to be overtaxed relative to other financial intermediaries. In light of this, we suggested that a reduced corporate tax rate or an across-the-board deduction applicable to all life insurance companies would be a far superior way of reducing the aggregate tax burden of the industry compared to the present collection of complex, inflexible and unusually incomprehensible provisions. Accordingly, we support the taxable income adjustment mechanism as set forth in the proposal.

We believe that the magnitude of the adjustment factor may have to be raised or lowered to generate the appropriate aggregate tax burden on the industry. The 25 percent deduction would result in life insurance companies paying a tax no greater than 34.5 percent of their taxable income (and, for small life insurance companies, a much smaller percentage). This percentage is not substantially greater than the effective tax rate of other financial intermediaries. Also, we would anticipate that the effective tax rate of life insurance companies may be significantly lower than this nominal 34.5 percent. First, other tax preferences permitted by the Internal Revenue Code would need to be taken into account. Second, we anticipate that the substantial benefit derived from the ability to expense the acquisition costs of the policies, as well as the substantial benefits still allowed by the proposed reserve rules, would reduce the effective tax rate further. We are continuing to examine the various factors which enter into the determination of the appropriate tax burden on income flowing through life insurance companies.

7. Other issues relating to company taxation

With respect to tax-exempt income and reinsurance, the proposal essentially would retain current law. For life insurance companies with foreign source income, the foreign tax credit limitation would be computed under the method generally applicable to other taxpayers. Finally, the current law definition of a life insurance company would be retained but with a special rule added to make it clear that funds held with respect to contracts that do not involve permanent purchase rates guarantees (primarily contracts issued in connection with pension plans) would not be treated as insurance reserves of any kind. In other words, in applying the 50 percent test, these types of reserves would not be counted in either of the numerator or the denominator.

Treasury supports these aspects of the proposal.

8. Consolidated returns.

One issue not addressed by the proposal that raises some important concern is the treatment of consolidated returns filed by affiliated groups containing one or more life insurance companies. Of course, some of the problems which arise under the present three-phase system regarding the consolidation of life companies would be eliminated by the proposed system. On the other hand, the proposed small company deduction and taxable income adjustment raise serious potential consolidated return problems. For example, proper rules must be instituted to prevent a non-life company from artificially shifting income to a life affiliate in order to derive a benefit from the taxable income adjustment. Rules will also have to be put in place to prevent a life insurance company from dividing its insurance operations into separate companies, one of which has taxable income, which would be subject to the small company deduction and the taxable income adjustment, and one of which has a taxable loss.

B. INDIVIDUAL TAXATION

1. Definition of life insurance

TEFRA added to the Internal Revenue Code a temporary definition of life insurance applicable only to "flexible premium" life insurance products. Under this definition, a flexible premium policy can qualify as life insurance by satisfying one of two alternative tests:

Alternative 1.—Premiums cannot be paid in more rapidly than the "guideline premiums" and a minimum ratio of death benefit to cash value must be maintained. This minimum ratio, known as the "corridor" is 140 percent until the policyholder reaches age 40 and declines by 1 percent each year until the policyholder reaches age 75.

Alternative 2.—The cash value at any time during the life of the contract cannot exceed the net single premium for that policy at that point in time.

The proposal would use this same framework, with its two alternative tests, to provide a permanent definition of general application. However, the proposal would tighten some of the limitations in the current definition in an attempt to exclude certain policies which are overly investment oriented. In particular:

Premiums could not be paid under a policy more rapidly than they would be paid under a policy calling for ten equal annual payments;

The policy could not endow before the policyholder reaches age 95.

Under the test of Alternative 1, the "corridor" provision would be expanded to require a death benefit to cash value ratio of 250 percent until age 40, declining to 110 percent at age 75. (The "cash value" test of Alternative 2 would not be changed by the proposal.)

As with the change in the method of computing reserves, Treasury believes that the proposed tax definition of life insurance is an important and significant step in the right direction. In particular, we support the provision that premiums cannot be paid more rapidly than they would be paid if the policy required the payments of ten equal annual premium payments. We also support the proposed rule that the contract may endow no earlier than age 95.

These two rules provide some assurance that life insurance policies will not be overly investment oriented. As we testified earlier, policies endowing earlier than age 95 and single premium policies tend to provide a relatively high investment return and only modest amounts of pure insurance protection. We believe that these rules impose reasonable limitations that will not adversely affect the vast majority of life insurance sales. It is our understanding that the great majority of policies sold satisfy these requirements. In addition, Canada recently imposed similar requirements in defining life insurance for tax purposes.

Our only major concern with the proposed definition of life insurance is that it allows a policy to qualify as life insurance even though it would have a degree of investment orientation which could be viewed as excessive if the interest rates paid to the policyholder significantly exceeded the minimum rates guaranteed in the contract. While the proposal does not discuss the minimum interest rates which would be required in determining the guideline premiums under this alternative, even under a 6 percent minimum rate a substantial amount of investment orientation is possible.

In our view, a good measure of the investment orientation of a life insurance contract is the ratio of the aggregate investment income to cumulative mortality and loading charges, measured at a time when the policy might be expected to terminate. For this purpose, we have used age 70 as an average termination date.

Under the TEFRA definition of life insurance, it is possible to sell to a 35-year-old individual a $100,000 policy calling for a gross single premium of $18,200, of which 10 percent represents a loading charge. The Net premium of $16,400 is the guideline single premium based on a 6 percent interest rate and 1958 CSO mortality tables. If the company actually credits interest income of 8 percent in each year, mortality charges are based on 85 percent of the 1948 CSO table rates, and the policy calls for increasing death benefits in the minimum amount necessary to maintain the required corridor of insurance protection, then by age 70 the aggregate investment income credited will be $195,900 while cumulative insurance costs (mortality and loading charges) will be only $21,900. The ration of these two amounts is almost 9:1.

We believe that the degree of investment orientation permitted under the TEFRA guidelines is far too great. Hence we strongly support the tightening of the TEFRA guidelines. For the policy purchaser described in the example above, the most investment-oriented policy permitted under the proposal would limit premium payments to $2,360 annually for 10 years (including a 10 percent loading factor). Under the same assumptions as above regarding interest credited, mortality charges, and loading charges, the cumulative interest income by age 70 would be $160,300 while cumulative mortality and loading charges would be $34,700. The investment/insurance ratio is reduced by almost half, to 4.6:1.

As these examples illustrate, the proposed tightening of the TEFRA guidelines would be a marked improvement and we strongly urge that this feature of the proposal not be relaxed. In fact, as stated above, we are concerned that the proposal may not go far enough in limiting the potential investment orientation of an insurance policy. As the first example in our earlier testimony showed, a traditional whole life policy has an investment to insurance ratio which does not significantly exceed 1:1 at any time during the life of the policy.

2. Annuities

The proposal would make several changes in the provisions relating to income distributions from annuity contracts. In general, the thrust of these changes is to conform the rules on income distributions to those applicable to individual retirement accounts. The penalty on premature distributions from annuity contracts, however, would be maintained at 5 percent.

Treasury believes that, in the context of the broad revision of the tax treatment of life insurance companies and their products, the proposed changes to the income withdrawal rules are reasonable and we support this aspect of the proposal.

3. Policyholder loans

The proposal would limit the deduction for interest paid on policyholder loans to that which is paid on a principal sum of $50,000 or less per person. We understand that this proposal will apply to loans that are actually loans from an insurance company or that represent loans secured by a pledge of the policy, but only to the extent of the cash value of the policy. Thus, the limitation would not apply to interest paid on a loan secured by a term policy on the life of the borrower payable to the lender.

Some limitation on policyholder loans is essential to prevent taxpayers from purchasing large policies which contemplate a program of regular and substantial borrowings primarily to obtain the combined tax benefits from the interest deductions on the borrowed amounts and the failure to tax interest or dividends earned by the investment in the policy. In recent years, these "minimum deposit" arrangements have been heavily promoted as tax shelters rather than as a form of life insurance protection. The promotional material for one such plan speaks of "minimal insurance benefits early on in the policy" and promises "500% tax deductible interest expenses to dollars invested." Another such plan promises "large tax deductions without investment risk" in a "truly personal tax shelter." All of these plans are carefully crafted to avoid the restrictions in present law on systematic borrowing plans.

The proposed disallowance of the deduction for interest paid on loans of $50,000 or more should effectively put an end to these tax shelters masquerading as life insurance. At the same time, a reasonable ceiling should not interfere with borrowings against insurance policies which are for legitimate, non-tax reasons (*e.g.,* college tuition, medical emergencies, etc.). Of course, loans in excess of $50,000 would still be obtainable; the taxpayer simply would not be able to obtain an interest deduction for interest paid on amounts borrowed in excess of $50,000. Although the tax shelter problem we have raised could have been addressed thorugh a provision similar to that created for pension loans in TEFRA, we believe that the nondeductibility of interest on loans in excess of $50,000 would seem to respond adequately to our concerns. Hence, we support this aspect of the proposal.

4. Computation of investment in the contract

Upon the surrender of an insurance policy or a cash withdrawal, the taxpayer's investment in the contract (for purposes of determining the amount which would be treated as taxable income) would be computed by reducing his aggregate premiums by the cost of term insurance protection. As we stated in our earlier testimony, we believe that this result is conceptually correct and appropriate to prevent taxpayers from using cash-value life insurance policies to pay for term insurance protection out of pre-tax dollars. These legitimate concerns need to be weighed against the possibility that this change would unduly discourage traditional savings through life insurance. Use of a standard table for determining the cost of term insurance would make this change more easily administrable and would relieve insurance companies of the burden of calculating the cost of term insurance protection provided.

5. Group term insurance

The proposal would extend the impact of the nondiscrimination rules under section 79(d) to all benefits made available to group term life insurance, not simply the exclusion from gross income of the cost of the first $50,000 of insurance. As we have previously stated, we feel that this change is appropriate. Often, the principal benefit of section 79 in a discriminatory plan is not the $50,000 exclusion but the use of the uniform premium table or the complete exclusion for the cost of insurance provided to a retired or disabled employee. Unless the nondiscrimination rules are extended to these benefits as well, group term life insurance will remain as a significant exception to the rules precluding discriminatory forms of tax-favored compensation generally.

C. EFFECTIVE DATES AND TRANSITION RULES

1. Company taxation

The new system for the taxation of life insurance companies would go into effect on January 1, 1984. Treasury agrees with this proposed effective date.

The most difficult transitional issue concerns the changes in the method for computing reserves. The reserve method applicable to any given policy has two main consequences. First, in each year in which the policy remains in force, the reserve method determines the amount which the company can deduct for additions to reserves. Under the method set forth in the proposal, the deduction for additions to reserves would be significantly lower than under present law in the first year of the policy but slightly higher than under present law in every other year of the policy. Second, the level of reserves with respect to a policy determines the sum which must be brought back into income when the policy terminates (either through lapse, surrender, or death of the policyholder). The higher the level of reserves, the more that must be brought back into income. The reserve with respect to any given policy under the proposed new reserve method would be lower than under present law.

Allowing an insurance company to revalue its reserves using the new reserve method with respect to old policies would allow a significant windfall. For example, consider an insurance company whose reserve on a given policy if $1,200 under current law, but which would have reserves of $1,000 under the proposal. In general, this company will have received $1,200 in deductions under current law for additions to reserves over the life of the policy to date. If the policy is surrendered for $1,000, the company would be required to include the excess $200 in income, since this excess reserve was not needed to pay a policy benefit. If, however, the company can revalue its reserves to $1,000 under the proposal's reserve rules, it would not be required to restore any amount into income since its reserves would match exactly the amount paid to the policyholder.

In order to prevent this windfall, the proposal would allow companies to use the new reserve method on old policies but would require the difference in the overall level of reserves as computed under the two methods to be brought back into income ratably over 10 years. We support this provision and we would oppose any provision that would have the effect of "forgiving" the potential recapture of tax benefit inherent in the existing reserve accounting rules.

2. Individual taxation

Treasury supports the proposed effective date provisions regarding the treatment of life insurance products and annuities. In particular, we believe that the limitation on the deductibility of interest on policyholder loans should be applied to all new loans, whether made in connection with old or new policies. However, we believe that the definition of life insurance should provide companies ample time after enactment to bring the policies into compliance with the provisions.

3. Previously deferred amounts

The proposal contains no specific recommendation with how to deal with the "phase III overhang." Four options are listed: (1) pro rata inclusion in income over some period of time; (2) indefinite deferal with a requirement that losses be used first to offset deferred amounts; (3) take the deferred amounts into income as existing policies terminate; and (4) leave in place the rules of the 1959 Act. A fifth option would be to forgive the phase II overhang entirely.

Treasury could support any option short of total forgiveness. Companies benefiting from this deferral provision should not be able to profit from the revision of the system for taxing life insurance companies by obtaining permanent forgiveness of amounts which Congress always intended to be brought back into income eventually. While we do not favor a phase-in over an unduly short period of time, we do not believe these amounts should be entirely eliminated from the tax base.

This concludes my prepared remarks regarding the proposal. I would be happy to answer any questions that the Subcommittee might have.

Mr. GUARINI. In regard to small companies, would you be good enough to address yourself to Treasury's position as to what consideration should be given to small companies and how small companies should be defined in Treasury's view?

Mr. CHAPOTON. Under the proposal, the small companies are given a benefit.

We raise a question generally as a tax policy matter of whether there is a justification for small companies to be given a tax benefit just because they are small companies when other small companies are not given such benefits; but small insurance companies have had such benefits for a number of years. They have had them through the use of provisions which are not, we think, targeted to meet their goal.

Therefore, if you are going to keep some benefits for small companies, we think the approach of the proposal is quite sound.

Mr. GUARINI. Would the definition of $1 to $4 million and a sliding scale of 60 percent be satisfactory?

Mr. CHAPOTON. Yes, I think the definition is going to be arbitrary no matter what definition you pick.

Basically, we would not oppose the selection of the proposal.

Mr. GUARINI. Then the present section 818(c), which is the present method of defining the reserves and evaluating the reserves, the Treasury would be opposed to a continuation of that.

Mr. CHAPOTON. We would oppose the continuation of it, correct.

Mr. GUARINI. So therefore, a small company would be defined as any company that makes more than $4 million?

Mr. CHAPOTON. Under $4 million, yes, sir.

Mr. GUARINI. In regard to the suggestion of the stock subsidiaries, the mutual companies and keeping the stock companies taxed as mutual companies, does Treasury have any opinion on that?

Mr. CHAPOTON. Our testimony states that we are supporting the provision of the proposal which would say if more than 80 percent of a stock company was owned by a mutual company, then that stock company is treated as a mutual company.

At first blush, that seems almost unfair. It seems unfair but the more we analyze it, I think such a proposal is required to prevent a mutual company from forming a stock company which is, in fact, another mutual company. But since their stock is outstanding, it would not be a mutual company under the general definition and distributing earnings to the policyholders of that company without tax at the company level.

In other words, there would be no tax on that company except to the extent of its retained earnings.

But I would concede there is a difficult interplay here between stocks and the mutuals. For that proposal to be sound, you have to assume that the stock subsidiary of the mutual is basically a mutual itself.

I think that is probably a reasonable assumption but it is one that could deserve further discussion.

Mr. GUARINI. Do you think that there is a possibility of the mutual companies having an advantage if they are able to operate out of stock subsidiaries?

Mr. CHAPOTON. Yes, that is correct. If a mutual company were taxed as a stock company, there would be no tax on its income to the extent it is distributed under their single-phase system.

So that gets back to the ownership differential, and that is something that we have to deal with. I think we have to deal with it in the context of a company that is in fact a mutual, whether it appears to be a stock or not.

Mr. GUARINI. But it still has to be thought out and there could be more colloquy discussion.

Mr. CHAPOTON. I think the proposal is sound. I think there will be further discussion on this point. We will certainly entertain further discussion of it, but our present conclusion of it is that the proposal is sound.

Mr. GUARINI. Thank you very much.

Chairman STARK. Thank you.

I missed the conclusion of your testimony and I am not sure I have read it all in detail, but is it a fair summation to suggest that basically almost all the points in our proposal are concurred in with the Treasury and that the open or the nonresolved part is the ownership differential?

I may have missed a point in here. With particular reference to the small companies, I gather it is a principle you support.

Mr. CHAPOTON. We support, correct. We do not oppose.

Chairman STARK. The way we approach that, you would——

Mr. CHAPOTON. It is hard to justify on a tax policy ground, but we understand the reality.

Chairman STARK. You would, I guess, say if there must be one, ours is a way you would not oppose.

Mr. CHAPOTON. It is certainly superior to existing law.

Chairman STARK. If that is not damnation by faint praise, I will accept it.

The definition, there will be some question about the 250 percent and there will be some question about the 10 years, but I think your testimony indicates that those are areas in which you concur and, indeed, may have suggested some of those as appropriate limits in the definition.

Mr. CHAPOTON. That is correct. We do concur in those limits and we do suggest that there may be reason to examine whether those rules are tight enough.

We talk about the ratio of investment income to mortality charges in the policy as one way of testing whether those are sufficient.

Chairman Stark. Thank you.

Now the tougher ones, and I don't mean to put you on the spot. You may not have an answer on it.

It is my understanding that we are all talking generally that if a proposal in terms of the aggregate revenue were to come out to be absolutely budget neutral, it would in fact have to yield about $4.7 billion in revenue.

Mr. Chapoton. That is the estimate under the TEFRA stopgap, correct.

Chairman Stark. And it was suggested by a rather prominent member of the other body the other day. I have heard secondhand that his feeling was that maybe a better level might be around to connect a total of $3 billion.

I don't ask for your comment on that but I would ask you whether, if in that range of $3 to $5 billion, is an area in which anybody has any feeling ought to be that—I am asking for a judgment and maybe this is one you would rather not answer at this point. It is something some day we will have to discuss.

Mr. Chapoton. We have to address it. I am frankly not prepared to address it yet.

But I would point out one thing, that the 4.7 is a rather mechanical number in itself. As we all know, during the conference on TEFRA, stopgap was shortened a year. That left the higher income out there in the post-TEFRA, so that we are now facing the dilemma that anything we do to bring us back to TEFRA is a revenue loss as compared to the present budget.

Chairman Stark. The Chair has no interest in either of those numbers, but I guess what it was getting to is whether you thought that 3 was an outrageously high or low figure or that 4½ was outrageously high or if those ranges seemed realistic to you.

You are not thinking of $10 million, I am sure.

Mr. Chapoton. Mr. Chairman, I am just not prepared to address that question yet. We have done some looking at it. It is going to eventually be a judgment call, I think, but I am just not prepared.

Chairman Stark. Mrs. Kennelly.

Mrs. Kennelly. Thank you, Mr. Chapoton, for the excellent statement. I know having listened to you on other subjects that I am amazed always how well you do, whether it be leasing yesterday or insurance today.

Could I just take you a little step further regarding what the chairman was talking about?

You didn't give a definitive answer on TEFRA, but the Stark-Moore proposal has a figure attached of $4.5 billion. Do you look at this as a hard figure?

Mr. Chapoton. No, I think the staff is agreed that we are not confident that that figure is sound. It will really be a matter of a few more weeks before we are confident as a mechanical matter what number this type of proposal would raise.

Mrs. Kennelly. You were sitting there when we had the exchange between Messrs. Moore and Duncan and Stark about next week. I take it we won't have those hard figures then?

Mr. **Chapoton**. No, but actually I think that would not impede the effort because the figure eventually is going to be determined by the adjustment that the committee decides to put in—25 percent now—so you can adjust the revenue level pretty easily by changing that figure.

Mrs. **Kennelly**. Let me turn to another subject, Mr. Chapoton. As you know, the Stark-Moore proposal leaves open the question of what to do about the phase III overhang. In the little pamphlet there were four options, and there is a possibility of a fifth option, that we just forget about that amount.

Have you any preference of those four or five options that I just suggested?

Mr. **Chapoton**. I think we would not mind any of the first four. We would oppose the fifth.

In other words, we do not think it is appropriate to simply forget about the overhang.

Mrs. **Kennelly**. You would not forgive it?

Mr. **Chapoton**. We would not forgive it.

Mrs. **Kennelly**. What about freezing it?

Mr. **Chapoton**. That is certainly a possibility. I am not ready—I guess we could go along with that. I am not sure that that would be my first choice.

Mrs. **Kennelly**. I kind of like it because I figure if we are going to have a new start, let's have a new start with all new rules.

Just a few minutes more, Mr. Chairman.

Mr. Chapoton, it is not clear from your testimony exactly where Treasury stands on the ownership differential, or maybe I should say, yesterday I might not have thought it was clear. You did speak to that at great length, and I guess what I get out of your testimony is that it is something that you think is still open to review.

Mr. **Chapoton**. Definitely. It is still open to review.

The single toughest intellectual and practical problem in this proposal—and I think we in the committee need to consider it further—as I pointed out in our statement, this proposal has a lot of discriminatory effects. It is arbitrary in a lot of ways, but I am afraid that those statements will apply to any solution to this problem.

What we have to find is the one that is least discriminatory and least arbitrary.

Mrs. **Kennelly**. Well after listening to your testimony, it seems that you really are sympathetic toward the mutual company feeling that the 23-percent figure is high.

But I hope you remember that if the figure goes too low, then you have a problem on the other side. So it is very delicate.

Mr. **Chapoton**. That is correct. It is very tricky.

But before you address the 23, before it is too high or low, I think you have to address the conceptual soundness of the proposal, which is my approach. I would address that and decide whether it is conceptually sound or not, and then decide what the percentage level should be if you decide that that is sound.

But you are right. That aspect alone would be a difficult part of it.

Mrs. **Kennelly**. So you are saying we must make sure that how we come to the 23 percent is conceptually right.

Mr. CHAPOTON. No, I would say first, make sure that you want to follow the base, that is, the presumed rate of return on an assumed equity base, which is what this proposal does. First you establish the base and then you apply a 23-percent rate to it.

The first question is how you establish the base, and you see a lot of problems in the base. And the second question is how you arrived at 23 rather than 20 or 25.

Mrs. KENNELLY. So we really have to continue to go right to the beginning and look at it?

Mr. CHAPOTON. That is right, yes.

Mrs. KENNELLY. How we get that base?

Mr. CHAPOTON. Yes, that is correct.

Mrs. KENNELLY. Did Mr. Guarini go into subsidiaries of mutual companies?

Chairman STARK. Unfortunately, Mrs. Kennelly, the Chair was over voting and we left Mr. Guarini in charge alone. So only the reporter and the audience know.

Here he is.

Mrs. KENNELLY. Mr. Chairman, Clint just told me it is on the record.

Thank you very much, Mr. Chapoton.

Chairman STARK. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Chapoton, we appreciate your testimony and certainly appreciate the representatives of your office working with us throughout this project and trying to come up with a framework for a bill.

In looking at your testimony, having heard it and having read it in full, I think there were some items you were not able, because of constraints of time, to discuss. But it appears to me from reading over your testimony that with the exception of the comments you made about ownership differential and possible changes in that area, you seem to support, according to your written testimony, all the other aspects of the bill.

Am I correct on that?

Mr. CHAPOTON. Certainly we support the basic thrust of the bill. Just recalling from memory—I have been over the details of it—I think we can support most the other aspects.

In a couple of instances, we think we want to examine whether it should go further, a definition of life insurance being one. The policyholder, loans, we support that provision.

I think some discussion is going to be held on whether the $50,000 level is the appropriate level. And also, on the question of reserves on cash surrender policies, adding or removing from policyholders' bases the cost of term insurance, we are pointing out that that might have a significant impact on a traditional savings element of life insurance.

There may be one or two other instances, but I think with those exceptions, generally, we are supporting the proposal.

Mr. MOORE. As I look at your testimony, from reading the comments in the case of single-phase taxation, there was support. Reserve calculations, there was support on the company taxation. Ownership differential, the problems we all know are there we have got to work out. And stock subsidiaries of mutual companies, you supported the treatment in the proposal. Small company exemption was supported. Taxable income adjustment at the end was supported.

Mr. CHAPOTON. On that, of course, with the precaution that we have to decide what mechanism we support.

Mr. MOORE. We had a question about consolidated returns too. In individual taxation, again you just commented you support the thrust of the bill.

In some cases, you think the proposal ought to go further—policy loans, definition of life insurance, computation investment in the contract for support.

Going to company taxation, item C or division C, of your testimony, again you support the idea of how the companies are taxed.

So it appears to me we have your support with the exception of going a little bit further in some cases and definitely in the case of the ownership differential.

We need more complete revenue figures from your office by next Tuesday.

Do you think we can have these figures by next Tuesday?

Mr. CHAPOTON. We may have a better fix on it. I don't think we will be finally comfortable by that time on the overall level of taxation.

I think we know more about the magnitude of a particular change, the effect of a particular change on revenues, but the overall level of the industry taxation, we need some more information.

I have talked to our revenue estimators, the joint committee revenue estimators who are working together on this, and I suspect it will not be finally available that quickly.

Mr. MOORE. Would you think that by mid or late September when we will have a real markup in this subcommittee of the legislation itself, that we would have some better revenue estimates?

Mr. CHAPOTON. Yes, I am told that by late August we will have good revenue numbers.

Mr. MOORE. We appreciate your cooperation, Mr. Secretary, and urge that you continue to work with us. I know you will. And in the month of August we will try to begin to take the framework and work out the technical problems we have in front of us.

Thank you.

Mr. CHAPOTON. Thank you.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Just a couple of quick questions. Mr. Secretary, the estimate, as I understand it, of revenues from the insurance industry in the budget was $4.7 billion. Is that correct?

Mr. CHAPOTON. I think our estimate is 4.5 from this proposal. I am not certain.

I think the industry estimates vary to some extent. Let me see if we have a better figure on that.

You are talking about the estimate of the present law? TEFRA expires at $4.7 billion next year, correct.

Mr. DORGAN. Without respect to how the money is extracted from the industry, does Treasury have any general feeling about what the level ought to be?

In an earlier response to the chairman, you indicated you were not prepared to give a specific answer. But the answer really does not hinge on the specifics of the extraction method. It is really a philosophical question, isn't it?

Mr. **Chapoton**. Well, I think I agree; partly philosophical and partly, I think, the more meaningful figure to me is the rate of tax, the average rate on this industry as compared to industries with which they compete, other financial intermediaries.

I just think I am not yet comfortable that I have examined those facts enough to say what the level should be. And I think that it is a key question that we will have to address. We will certainly have a recommendation on that but we just do not yet.

Mr. **Dorgan**. We will get some guidance from you?

Mr. **Chapoton**. Yes, sir.

Mr. **Dorgan**. I appreciate that.

The testimony is interesting and, in many cases, quite supportive of the structure that Congressman Stark and Congressman Moore have developed. I appreciate the testimony.

Mr. **Chapoton**. Thank you.

Chairman **Stark**. Thank you very much, Mr. Chapoton. I appreciate your testimony.

Again, I want to thank the members of your staff who have been so helpful to us during this. We look forward to continuing to work together to see this legislation completed.

I guess I wanted to ask just one final question.

Is it not your feeling that at this point before we can get more accurate empirical data and before we can now really see the impact at least of those areas where there is general agreement, that is absent the differential, that it really is essential for the staff, the Treasury and certainly our deliberative process that we have a draft in far more detail so that we can answer specific questions, both of the industry and of the Tax Committee?

Mr. **Chapoton**. Yes, Mr. Chairman. I think the next step, in spite of the very significant open questions, the two significant ones, the ownership differential and the overall levels of taxation, that drafting is in order so that we can get advice on how a particular provision will affect companies.

They can give us that advice best once they see the specific legislative language of a proposal.

Chairman **Stark**. One other question.

It has been the Chair's feeling that the overall level for taxation is best adjusted by a single factor, whether that be a deduction of the rate or whatever, and that factor ought to be a goal toward which this committee ought to be moving.

Mr. **Chapoton**. We concur, Mr. Chairman.

Chairman **Stark**. And second, that the only other adjusting factor, and that ought to be decided before the overall amount of revenue, is the balancing issue that is now to be decided and that ought to be determined before we calculate that overall level of revenue.

Mr. **Chapoton**. Yes, I think it will have to be determined first.

Chairman **Stark**. Thank you very much.

Mr. **Chapoton**. Thank you, Mr. Chairman.

Chairman **Stark**. Our next group of witnesses are a panel consisting of Mr. Ian Rolland, chairman and chief executive officer of the Lincoln National Life Insurance Co., and Mr. Hartzel Lebed, president of the Connecticut General Life Insurance Co., who have been selected to present the broad, general views, I guess, of the stock-owned segment of the life insurance industry. They will be followed by the mutual life insurance companies.

The order of their appearance was determined by a method that is unknown to the Chair, and I presume is not to be determined as an order of preference but as the luck of the draw.

I would also ask the indulgence of the witnesses in the panel—and it would be fair game for the members to remind the Chair, who finds this very interesting—that if we are to finish by 7 o'clock tonight, we ought not to run over, in fairness to other witnesses, much over 1 hour a panel. Some of the panels will have more than five members. We will be running the time clock. The Chair does not intend to be very tight in holding to that timeframe unless it becomes necessary, but it is there to remind those of us, principally the Chair, who get carried away at the sound of their own voice, to keep it short.

Having asked the committee's indulgence in that, I want to welcome Mr. Rolland and Mr. Lebed to the committee and ask you to proceed. We have your prepared testimony. You may proceed in any manner you choose.

The acoustics in the room are not the best. There is a rush for testimony. If those people looking for copies of the testimony could tiptoe quietly back to their seats, the other members will be able to hear the testimony of our witnesses and the committee will be able to hear it.

With that admonition, please proceed.

STATEMENT OF IAN M. ROLLAND, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, LINCOLN NATIONAL CORP.

Mr. ROLLAND. Thank you, Mr. Chairman and members of the subcommittee. My name is Ian Rolland and I am chairman and chief executive officer of Lincoln National Corp., Fort Wayne, Ind. I appreciate your invitation to appear today to discuss the Federal taxation of life insurance companies and their products.

I am appearing today with my friend and colleague, Mr. Hank Lebed, of the CIGNA Corp. You have invited the two of us to discuss the impact on stock life insurance companies of the July 14, 1983, insurance income tax proposal.

Mr. Lebed has filed a written statement on this subject with the committee and I wish to express my agreement with the general principles set forth in that statement.

Mr. Lebed and I have agreed that I would take the lead in discussing a number of items in the proposal, particularly our concerns over appropriate revenue levels, the treatment of reserves and the taxation to individuals of life insurance products.

Mr. Lebed will then proceed to cover the remaining issues of importance to stock companies.

Before going further, I would like to say that we certainly do not purport to talk for 1,900 stock life insurance companies in this country. Nevertheless, I think the views that we will share today with you represent the views of a substantial portion of those stock companies.

Mr. Chairman, I am pleased to inform you that stock life insurers can support the proposals set forth by you and Congressman Moore.

The framework and overall thrust of the proposal should generally be appealing to stock companies even though we may be constrained to disagree on some particulars.

We say this even though stock companies will be significantly affected by the proposal. Our preliminary estimates show that the aggregate 1984 stock taxes would rise to $1.8 billion under the proposal, an increase of some 50 percent over what we would pay under the provisions of the 1959 act if they were in effect, and more than twice the tax that would be raised from stock companies were the temporary provisions of TEFRA to be extended to 1984.

To obtain the specific data that you requested on the impact of the proposal on stock companies, we asked members of the stock company information group to share with us the extent to which their tax liabilities for 1982 would change if the proposal were in effect.

While the results are mixed, it is clear that no company showed a decrease in taxable income. To the contrary, some companies indicated that their tax liabilities would rise moderately in the range of 10 to 25 percent. Others said their liabilities would more than double, and in one instance, the increase was sevenfold; in fact, for Lincoln National Life itself, my own company, you would be interested to know our 1982 tax liability of $18.1 million would rise to $35.5 million under the new proposal. We also estimate that the proposal would produce a liability for us of $41.1 million in 1984.

We believe that many stock companies could strongly support the proposal for corporate tax changes if certain modifications were made in the treatment of reserves.

Specifically, we urge you to consider three adjustments. One, adhere to the suggested requirement that reserves be computed on a preliminary term basis including the proposal's cash value floor, but use the Commissioner's reserve valuation method, rather than the full preliminary term method. Two, recognize for tax purposes reserves based on interest and mortality assumptions used for annual statement reporting. And three, make the proposed changes truly a fresh start basis and do not require us to recapture the differences between reserves on the old basis and those on the new basis.

The written statement filed by Mr. Lebed comments in detail on the first two of these changes, but I wish to emphasize particularly on the need for the third change.

It is important to note that not all life insurance companies derive the same benefit from prior reserve deductions due primarily to their differing tax postures under the multiphase system of the 1959 law.

Furthermore, under the proposal, adding the reserve recapture item would not increase the tax liabilities of most mutual life insurance companies; it would, however, increase the tax on most stock life insurance companies.

In the course of moving from the 1959 act to a single basis system, we hope you will refrain from imposing recapture items on us, but rather should make the fresh start complete.

With these changes stock companies' tax liabilities under the proposal would become much more manageable. In making such changes, we believe that the subcommittee should also consider reducing the overall industry tax liability, which we estimate under this proposal to run to $4.4 billion in 1984 based on the assumption of a 19-percent equity return from mutual companies. And of this $4.4 billion, $1.8 million would be paid by the stocks.

Burdens of this magnitude would seriously impair the ability of our industry to compete with other financial institutions, many of which enjoy very low effective levels of taxation.

It would also seem to us to be unfair to tax the life insurance industry at an increased level, while virtually all other corporations are experiencing reductions in tax, particularly as a result of changes brought about by the Economic Recovery Act of 1981.

We believe that an overall revenue of roughly $2.5 billion from our industry would be much more fair and reasonable, a result that could be produced after making the changes we have suggested regarding reserves and by an appropriate increase in the taxable income adjustment.

On the other hand, Mr. Chairman, I cannot overemphasize the depth of our concerns with the proposal's suggested treatment of life insurance and annuity products. Stock companies are particularly concerned with the proposal's suggested definition of life insurance.

We agree that such a statutory definition is needed to prevent abuses and we agree strongly with the suggestion that the definition embrace both a guideline premium test and a cash value test.

We also agree strongly that that test should apply to both flexible premium policies and fixed premium policies.

But the new innovative products that the stock companies have brought to the markets in recent years, that is flexible premiums and benefit policies such as universal life insurance, absolutely must have a rule like the guideline premium test if they are to compete on an equal footing with traditional life insurance products.

The nontraditional products would suffer needlessly under the strictures of a cash value only test.

Universal life is a highly consumer-oriented product. Consistent with the objectives of the TEFRA rules it is being purchased primarily by consumers who are looking for low-cost permanent insurance.

It is not being purchased as an investment. The Lincoln National Corp. leads the industry in universal life sales. Our consumer studies indicate that our customers are buying universal life primarily to obtain insurance protection.

We can support the general thrust of the proposal's suggested dual definition of life insurance. We must tell you, however, that we strongly oppose a number of the precise features of that proposal.

The rules enacted in TEFRA for universal life if expanded to all insurance products would, we feel, be more than adequate to assure that a consumer was purchasing a life insurance policy for its protection and not its investment features while also preserving maximum flexibility in life insurance product design.

It is not necessary and it would be overly restrictive to substitute for the TEFRA single premium rule a 10-pay rule as the proposal suggests. Insistence on the 10-pay rule would have the undesirable effect of forbidding any company from replacing one of its own contracts that has been in force for a number of years with a newer policy form providing better benefits and value to the policyholder.

In fact, over the last year, our agents have been offering to our own policyholders the opportunity to upgrade traditional previously insured products to universal life. The 10-pay life test would prevent virtually one-third of those people from upgrading to the more attractive newer products.

We think this is an unfair restriction on their ability to do so.

It is also unnecessary to enlarge the TEFRA minimum risk corridor of the guideline premium test as suggested in the proposal. This would only serve to force all products into the whole life insurance mold.

Even as enacted in TEFRA, the guideline premium test is far more restrictive than the cash value test as to amounts paid into the contract. It is therefore unnecessary to enlarge the corridor.

In closing, Mr. Chairman, I would like to urge the subcommittee to consider the propriety of the remaining individual tax changes suggested in the proposals.

First of all, for annuities, it was our view that TEFRA dealt with the annuity problem on a permanent basis. We see no evidence of abuse in the marketplace and we believe the TEFRA rules should be continued without change.

As to policy loans, we urge the committee to carefully consider the remarks of other invited witnesses appearing here today, whom we believe will answer and address the question fully.

But in this regard, the proposal's suggestion that the rules be applied retroactively to existing contracts strikes us as unfair; we suggest that any change you decide to make ought to apply prospectively only.

The proposed changes in the group term life insurance rules we believe should only apply prospectively as well.

Finally, we oppose the suggestion that a policy surrender basis be recomputed by removing the express or implicit mortality charges. We consider this unnecessary in that it will increase complexity and the cost of administering our contracts, with little or no revenue gain to the Government.

Finally, we endorse the idea of special rules for small life insurance companies and others will testify on that more fully.

We believe you should carefully hear their testimony and decide whether the present rules in the proposal are sufficient to deal with their problems.

Again, I thank you for your invitation to appear at this hearing to speak on these important matters. I believe with the changes outlined in this statement and with those to be made by Mr. Lebed that you will have the support of the stock life insurance industry. Thank you very much.

[The prepared statement follows:]

STATEMENT OF IAN M. ROLLAND

Mr. Chairman and Members of the Subcommittee, my name is Ian Rolland, and I am Chairman and Chief Executive Officer of the Lincoln National Corporation, Fort Wayne, Indiana. I do appreciate your invitation to appear today to discuss the Federal taxation of life insurance companies and their products. I am appearing today with my friend and colleague, Mr. Hank Lebed of the CIGNA Corporation. You have invited the two of us to discuss the impact, on stock life insurance companies in particular, of the July 14, 1983, Life Insurance Income Tax Proposal. Mr. Lebed has filed with the Subcommittee a written statement on this subject, and I wish to express my agreement with the general principles set out in that statement.

Mr. Lebed and I have agreed that I would take the lead in discussing a number of the items in the Proposal, particularly our concerns over appropriate revenue levels, the treatment of reserves, and the taxation to individuals of life insurance products. Mr. Lebed will then proceed to cover the remaining issues of importance to stock companies. Before going any further, however, we wish to emphasize that we do not purport to speak for each of the more than 1900 stock life insurers domiciled in the United States. Nonetheless, the views that we will share with you today have been discussed with, and agreed to by, a substantial and representative cross-section of the stock segment of our industry, including the members of the Stock Company Information Group.

Mr. Chairman, I am pleased to be able to inform you that stock life insurers across the Nation can support the Proposal set forth by you and Congressman Moore. The framework and overall thrust of the Proposal should generally be appealing to stock companies, even though we may be constrained to disagree on some particulars. We say this even though stock companies will be significantly affected by the Proposal. Our preliminary estimates show that aggregate 1984 stock company taxes would rise to about $1.8 billion under the Proposal, an increase of some 50 percent over what stock companies would pay in 1984 were the provisions of the 1959 law to remain in effect, and more than twice the tax that would be raised from stock companies were the temporary or "stopgap" provisions of TEFRA to be extended into 1984.

To obtain for you the specific data that you requested on the impact of the Proposal on stock companies, we asked member companies of the Stock Company Information Group to share with us the extent to which their tax liabilities for 1982 would change had the Proposal been in effect that year. While the results were mixed, it is clear that no company showed a decrease in taxable income. To the contrary, some companies indicated that their tax liabilities would rise moderately, in the range of 10 to 25 percent, others said that their liabilities would more than double (in one instance, the increase was sevenfold), and in still other instances we learned that 1982 operations losses either would have been significantly reduced or converted into taxable income. For Lincoln National Life itself, you may be interested to know, our 1982 tax liability of $18.1 million would rise to $35.5 million under the Proposal. We also estimate that the Proposal would produce a liability of $41.1 million in 1984.

We believe that many stock companies could strongly support the corporate tax changes suggested in the Proposal if certain modifications were made in the treatment of reserves. Specifically, we urge you to make three adjustments: (1) adhere to the suggested requirement that reserves be accounted for on a preliminary term basis (including the Proposal's cash value floor) for tax purposes, but use the Commissioners Reserve Valuation Method rather than a full preliminary term method; (2) recognize, for tax purposes, reserves based on the interest and mortality assumptions used for Annual Statement reporting; and (3) make the proposed changes truly on a "fresh start" basis and do not require us to recapture the difference between reserves on the old basis and those on the new basis. The written statement filed by Mr. Lebed explains why these modifications of the Proposal are appropriate, but I wish to emphasize here the particular need for the third change. Not all life insurance companies derived the same benefit from prior reserve deductions, due largely to differing tax postures under the multi-phase system of the 1959 Act. Furthermore, under the Proposal, adding the reserve recapture item would not increase the tax liabilities of most mutual companies, but only the tax burden of stock companies. Accordingly, in the course of moving from the 1959 Act to a single-phase system, you should refrain from imposing the recapture item on us, but rather should make the "fresh start" complete. With these changes, stock company tax liabilities under the Proposal would become much more manageable.

Beyond making such changes, we believe that the Subcommittee should also consider reducing the overall industry tax liability that would be imposed under the

Proposal, now estimated to be roughly $4.4 billion in 1984 (based on an anticipated mutual equity return rate of approximately 19 percent for 1984), of which about $1.8 billion would be paid by stock companies.

Burdens of this magnitude would seriously impair the ability of the life insurance industry to compete with other financial institutions, many of which enjoy very low effective levels of taxation. It would also be unfair to tax the life insurance industry at an increased level while virtually all other corporations are experiencing reductions in tax, particularly as the result of changes made by the Economic Recovery Tax Act of 1981. We believe that overall revenue of roughly $2.5 billion from our industry would be much more fair and reasonable, a result that could be produced, after making the changes we have suggested regarding reserves, by an appropriate increase in the "taxable income adjustment."

On the other hand, Mr. Chairman, I cannot overemphasize the depth of our concerns with the Proposal's suggested treatment of life insurance and annuity products. Stock companies are particularly concerned with the Proposal's suggested definition of "life insurance." We agree that such a statutory definition is needed. And we agree strongly with the suggestion that the definition embrace both a "guideline premium" test and a "cash value" test. The newer, innovative products that stock companies have brought to the market in recent years—flexible premium and benefit policies such as universal life insurance—absolutely must have a rule like the guideline preimium test if they are to compete on an equal footing with traditional life insurance products. The non-traditional products would suffer needlessly under the strictures of a cash value test.

Universal life insurance is a highly consumer oriented product. Consistently with the objectives of the TEFRA rules, it is being purchased primarily by consumers in the 30 to 35 age range who are looking for low-cost permanent insurance, not for an investment. Lincoln National Corporation leads the industry in universal life sales, and we have conducted a study to document these facts. I request that this study, which we will furnish to the Subcommittee, be made a part of the hearing record.

We can support the general thrust of the Proposal's suggested dual definition of life insurance. We must tell you, however, that we strongly oppose a number of the precise features of the Proposal. The rules enacted in TEFRA for universal life insurance, if expanded to all insurance products, would be more than adequate to assure that a customer was purchasing a life insurance policy for its protection, not its investment features, while also preserving maximum flexibility in life insurance product design. It is not necessary, and it would be overly restrictive, to substitute for the TEFRA "single premium" rule a "10-pay" rule, as the Proposal suggests. Insistence on a 10-pay rule would have the undesirable effect of forbidding any company from replacing one of its own contracts that had been in force for a number of years with a newer policy form that provides better value to the policyholder.

It also is unnecessary to enlarge the TEFRA minimum risk "corridor" of the guideline premium test, as suggested in the Proposal. This would only serve to force all products into the whole life insurance mold. Even as enacted in TEFRA, the guideline premium test is far more restrictive than the cash value test as to amounts that may be paid into a contract. It is therefore unnecessary to enlarge the "corridor." We would also urge the Subcommittee to consider whether it is truly desirable, as the Proposal suggests, to preclude the writing of endowments before age 95 and to ban all increasing benefit policies, regardless of how modest the increase may be.

In closing, Mr. Chairman, I would also urge the Subcommittee to reconsider the propriety of the remaining individual tax changes suggested in the Proposal. The proposed changes for annuities, in our view, are unnecessary in light of the rules adopted last year in TEFRA. Nonqualified deferred annuities are not properly analogized to IRAs, for the purchaser of the annuity does not receive a deduction for his premium payment as does the purchaser of an IRA. As to the suggested limitation on the deductibility of policy loan interest, we urge the Subcommittee to consider carefully the remarks of other invited witnesses appearing here today, who we believe will address the matter fully. In this regard, we note that the Proposal's suggestion that the new rules be applied retroactively to existing contracts strikes us as quite unfair, and we suggest that any change be made on a prospective basis by policy issue. The proposed changes in the group-term life insurance rules also present problems, particularly in that they are not adequately detailed in the Proposal and, hence, may be a source of confusion. Again, any changes in these rules should be made on a prospective basis by policy issue. Finally, we oppose the suggestion that a policy's surrender basis be recomputed by removing the express or implicit mortality charges. We consider this unnecessary in that it will increase complexity and the cost of administering our contracts with little or no revenue gain to the Government.

Despite these concerns, Mr. Chairman, we believe that, with appropriate adjustments, the Proposal can be made quite acceptable to most stock companies. I cannot assure you that all stocks will be happy with it. It must be noted that there are still other details to be worked out, the result of which may affect the tenor of stock company support. For example, while the Proposal speaks to the treatment of reserves for individual life insurance and annuity contracts with cash values, it does not give clearcut guidance as to the proposed tax treatment of reserves for other lines of business. This must be explored and carefully worked out. Further attention also should be paid to the sufficiency of the small company adjustment in the Proposal. As you will hear from the small company representatives you have invited to testify, the eligibility requirements for that adjustment well may be too stringent. Assuming, however, that small company concerns can adequately be addressed and that other items can be resolved to our common satisfaction, we think you can expect widespread stock company support for the Proposal, with modifications of the kind that we have noted.

Again, Mr. Chairman, I thank you for your invitation to appear at this hearing to speak to these important issues. I think stock companies can be expected to offer this Subcommittee their fullest cooperation in crafting the details of the proposed new statutory scheme for taxing our industry.

Chairman STARK. Thank you, Mr. Rolland.

Mr. Lebed.

STATEMENT OF HARTZEL Z. LEBED, PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO.

Mr. LEBED. Yes, sir, Mr. Chairman, and members of the subcommittee, I am Hank Lebed, executive vice president of the CIGNA Corp., and president of the Connecticut General Life Insurance Co. Thank you for the opportunity to testify.

Let me deal first with a few housekeeping items. I would very much appreciate my detailed written testimony being incorporated in the record.

Chairman STARK. Without objection, it will appear there in its entirety.

Mr. LEBED. Thank you.

Second, the Stock Information Group prepared a paper on return on equity for mutual companies for staff a while back and we would be happy to enter that into the record.

Third, we understand that the mutual companies are submitting written testimony this morning which we have not had a chance to review. We would appreciate the opportunity to do that before the hearing records are closed.

Chairman STARK. Let me ask unanimous consent of the committee that any of the witnesses today who would like to submit additional things in writing would be welcome to do so after the hearing. Their additional views will be included in the record.

Mr. LEBED. I will proceed.

My comments are going to focus entirely on the aspects of the proposal that deal with the taxation of life insurance companies, and I will emphasize the all-important issue of competitive balance.

First, I want to express my agreement with all the points made by Mr. Rolland, and I especially want to express my admiration for the very evenhanded process used and the very creative, thoughtful, and insightful work that has been done by Chairman Stark, Congressman Moore, and members of congressional and Treasury staff in developing what we feel is a very promising proposal for a single-phase tax structure for the life insurance business.

The combination of a single-phase structure along with a soundly conceived ownership differential provision that deals with the unique characteristics of mutual companies can, we believe, if properly developed, provide very fair and appropriate results for all concerned.

Now, from that general position, I would like to comment on those aspects of the Stark-Moore proposal that deal with the competitive balance, specifically the proposed provisions with respect to ownership differential, stock subsidiaries of mutuals, the taxable income adjustment, and the treatment of phase III accounts.

With respect to ownership differential, we fully endorse the Stark-Moore proposal's concept of measuring a return on equity, providing thereby a limitation on the deductibility of dividends paid to mutual company policyholders.

And that, in turn, we think would maintain competitive balance between stocks and mutual companies in our business.

Now, it has become eminently clear, as the chairman has already recognized, that since the proposal was released 2 weeks ago many criticisms will be leveled against this provision of the proposal.

We think it is terribly important that the great barrage of technicalities and numbers and arguments that you are going to hear not be permitted to obscure the basic issue, which is simply this: Both stock and mutual companies pay returns to their owners on their investments in the business and have after-tax retained earnings which are reinvested in the business.

In the case of stock companies, this return takes the form of dividends to shareholders which are not deductible.

In the case of mutuals, part of the return to owners takes the form of some of the dividends that are paid to their policyholder owners.

Now, the Treasury Department has often observed that to the extent that part of the dividends paid to mutual company policyholders are returns to owners, they, too, should not be deductible.

This is the objective of the ownership differential provision of the Stark-Moore proposal, and it is absolutely sound.

Now, I would like to comment briefly on some of the emerging criticisms about the ownership differential proposal.

First, it has been called a minimum tax that should be applied to stocks as well as mutuals. It is not a minimum tax. It is simply a limit on policyholder dividend deductions. Under Stark-Moore, if the taxable income of a mutual company before dividends is less than the equity return, then only the lesser amount would be taxable.

And the principle of limiting the deductibility of dividends to owners is already applied to stock companies by virtue of the principle that we cannot deduct dividends paid to our shareholders.

The second criticism is that the ownership differential is unfair because it taxes stock companies on income and mutual companies on net worth or surplus. This is fallacious. The Stark-Moore concept focuses on the return on net worth, and this return is simply another way of looking at income.

This feature of the Stark-Moore proposal is no more or less an excise tax on net worth, as has been charged, than is the basic Federal corporate income tax itself.

Third, it is argued that the proposed rate of return, which has been estimated would have been 23 percent in 1982 and is projected to be something like 18 to 20 percent in 1984, is too high. We disagree. The objective of Stark-Moore is and should be to arrive at a rate of return on equity to mutuals, which is equivalent to returns on equity in similar businesses.

One simple way to look at the appropriate range is to focus on the way stock companies price their products.

Both traditional products and the newer forms, such as universal life, are typically priced to produce a return after taxes of 15 percent. These are the kind of returns that the capital markets demand and the kind of returns that we have to produce if we are going to compete for equity capital in those markets.

A 15-percent after-tax return requires pretax returns in the 20- to 25-percent range, and the pretax return is what the Stark-Moore proposal is attempting to get at and should.

We also think that the proposal's three-factor formula for determining the rate is quite sound and will respond very well to changing economic conditions which seems important.

In the same vein, it is argued by opponents of this provision that the appropriate rate of return is the mutual companies' portfolio rate on its invested assets.

This would be, in our opinion, entirely inappropriate, because the portfolio rate on assets measures debt-type investments, that is, investments in instruments like bonds and mortgages averaged over many years.

The rate of return that is appropriate here is one that applies to equity ownership, which entails much greater risk and much higher returns.

I am confident that independent financial experts such as investment banking firms, accounting firms and business schools would fully corroborate our view on the validity of the return on investment concept and our views on how the appropriate levels should be approached.

The final criticism I want to comment on has to do with a provision that relates to the ownership differential, namely that of treatment of stock subsidiaries of mutuals.

In our view, it is essential, in order to avoid manipulation of the dividend restrictions, that stock subsidiaries of mutuals be treated as mutual companies. But we believe that the ownership control threshold should be 50 percent rather than the 80 percent in the proposal.

As a final comment on ownership differential, we note that the Stark-Moore proposal appears to achieve a revenue split in the general range of 60 percent for mutuals and 40 percent for stocks.

We have always maintained that that is about the right revenue split.

The current industry ratio, for example, of life insurance reserves the investment income on which is a major source of industry profits, is 65 percent for mutuals and 35 percent for stocks.

As a matter of fact, just about 1 year ago, an industry committee composed of both mutual and stock company CEO's agreed that an appropriate target revenue split was 60 percent for mutuals and 40 percent for stocks.

Now, turning to another subject, the stock information group supports the general concept of a taxable income adjustment.

Just as ownership differential is the key to competitive balance within the industry; the taxable income adjustment is the key to competitive balance with other financial institutions.

That adjustment provides a simple, effective mechanism for bringing the life insurance industry's total tax burden more nearly into line with the other financial institutions while doing it in an even-handed way, as between stocks and mutuals.

As Mr. Rolland stated, we suggest increasing the taxable income adjustment from 25 percent to something like 40 percent.

The last subject I want to comment on is the policyholder's surplus account, sometimes referred to as phase III account. If I can go back for just 1 minute to a point that Mr. Rolland made, he asked the subcommittee not to adopt the proposal to tax the so-called reserve overhang. This is an example of our belief that the committee should adopt a policy that the Life Insurance Tax Act of 1983 will constitute a prospective-only, fresh start, designed to produce fair, appropriate, competitively balanced taxes from 1984 forward and should not impose the additional burden of taxes on selected residuals from the 1959 act.

We believe this prospective-only policy should also apply to these phase III accounts. Let me elaborate briefly.

The current law contains special items of deferrals used by both small and large stock companies which have accumulated in the phase III accounts.

There is no provision in the proposal for taxing these amounts, and that is as it should be. We believe they should not be taxed.

Taking this 1959 act residual and taxing it would be inconsistent with a prospective-only, fresh-start approach. It would affect stock companies only, thereby distorting competitive balance. It would seem inequitable to stock companies in light of Congress' prospective-only approach when MODCO was eliminated, and it would weaken the financial stability of many smaller companies, and even some larger ones.

If the subcommittee should decide it needs to tax these phase III accounts, the only realistic option is option 4, described in the Stark-Moore pamphlet under which existing amounts in this account will be subject to tax only in the same circumstances as under the 1959 act.

To close, let me briefly summarize the key points made by Mr. Rolland and me regarding the taxation of life insurance companies.

Chairman STARK. Mr. Lebed, would you yield at that point. Because there is a vote on the dividend withholding which this committee is going to joyously support on the floor, I would like to recess for about 6 minutes. Then, to refresh our recollection, would you summarize when we return, and we will inquire.

The committee will stand in recess for 5 minutes.

[Recess.]

Chairman **Stark**. Mr. Lebed, we apologize for the interruption, and assure you that the $8 billion that just went down the drain with that vote will not be taken out of the hide of the life insurance companies that appropriately should come out of the banking industry and would you care to summarize which will refresh all of our recollections?

Mr. **Lebed**. I would like to briefly summarize the key points made by me and Mr. Rolland regarding the taxation of life insurance companies.

I believe stock companies can endorse the general framework of the Stark-Moore proposal as the basis for new permanent legislation subject to five concerns.

One, we are deeply concerned with the aggregate amount of income tax that the proposal, in its current form, would impose on the life insurance industry, and on its competitive position with respect to other financial institutions. It is substantially too high and should be reduced. Increasing the taxable income adjustment to something in the range of 40 percent would be a major step in the right direction.

Two, we support the concept of the special small company deduction, but we believe more work needs to be done to recognize the special concerns, competitive pressures and unique contributions of smaller companies to a competitive, consumer-oriented marketplace.

Three, we believe the commissioners reserve valuation method is an appropriate reserve standard for individual life insurance. Further, we would like the opportunity for our technicians to work with your staff with respect to reserves for other products. Most importantly, a prospective-only, fresh-start policy should be adopted with respect to the resulting reserve overhang and the phase III accounts.

Four, we want to see a fair and healthy competitve balance within the industry achieved. This can be accomplished by maintaining the proposed return on equity ownership differential concept with an appropriate rate of equity return on a legitimate equity base that is not subject to manipulation. We believe that the proposal's three-factor formula will yield appropriate rates of return.

Thank you, Mr. Chairman, for this opportunity to present our views. Mr. Rolland and I will be happy to answer any questions regarding our oral testimony or our more detailed written statement.

[The prepared statement and Stock Company Information Group paper follow:]

STATEMENT OF HARTZEL Z. LEBED, PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO.

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I am grateful for the Subcommittee's invitation to me to appear today to testify in connection with the Life Insurance Income Tax Proposal (the "Proposal") set out in the July 14, 1983, Committee Print (the "Pamphlet"). I understand that the Subcommittee selected the individuals it has invited to testify so as to elicit reactions that are as specific as possible to the expected impact of the Proposal. My testimony therefore will endeavor to respond to the specific inquiries made by the Chairman in his letter of invitation. At the same time, I wish to take this opportunity to provide the Subcommittee with more encompassing reactions to the Proposal, on behalf of a broader group of stock life insurance companies. I do not, of course, speak for all stock companies. Nevertheless, this statement has been discussed with a substantial and representative cross-section of the stock segment of the industry, including the members of the Stock Company Information Group, and I speak for a broader constituency than simply the company on whose behalf I appear.

As you are well aware, Mr. Chairman, stock life insurance companies, from nearly the inception of the Subcommittee's efforts to formulate a workable solution to the tax treatment of life insurance companies and their policyholders, have been identified as the advocates -- some would say the unreconstructed defenders -- of existing law embodied in the Life Insurance Company Income Tax Act of 1959. I trust that you will recognize it to have been our sincere belief that the provisions of that statute offered the most viable foundation for achieving sound, competitively neutral taxation of life insurance companies, thereby realizing the goals you and your colleagues have set out to achieve. Frankly, many stock companies were skeptical that a sound alternative could be found for the basic structure contained in existing law.

Despite these reservations, it is my view, and the view of those on whose behalf I speak, that you have managed to fashion a Proposal which, with very few substantive changes, can become a workable, durable solution to the tax treatment of life insurance companies and their policyholders. You, your colleagues, and the staff working group are to be commended for your efforts in crafting this Proposal, for the degree of cooperation you have extended to representatives of the industry itself, and, ultimately most importantly, for the quality of what you have produced.

I am here today to endorse the general outlines and most of the specifics of the Proposal as the basis for fashioning a regime by which to tax life insurance companies. I believe the Proposal proceeds from a sound, principled foundation. And the stock companies for which I speak offer you our full cooperation in working with the Subcommittee and its staff to effectuate whatever refinements that, after further deliberation, you conclude are appropriate.

In the balance of my testimony I will offer you our views on particular features of the Proposal. Most of our suggestions will be in the nature of refinements. But we do believe the overall revenue produced to be too high. Beyond that, there are certain features on which we find ourselves in sharp disagreement with the Proposal. Here we have in mind particularly the proposed definition of life insurance, which we believe will substantially hamper in the marketplace innovative products offered by stock life insurance companies, thereby conferring a tax-induced competitive advantage on mutual life insurers. There are one or two other respects, such as the reserve transition rule, in which we believe the Proposal contains a real bias in favor of the mutual segment of the industry. In some instances this bias may have been inadvertent; in others we recognize that its presence may have been dictated by practical necessity.

Before proceeding, however, I wish to address one threshold matter. It consistently has been our view that any sensible solution in this area should allocate approximately 40 percent of the aggregate industry tax burden to stock life insurance companies and the balance to the mutuals. I realize that there exists no unassailable basis for arriving at such a segment allocation. This range simply reflects our best judgment as to a reasonable division, taking account of the fact, among others, that a substantial number of companies in the stock segment of the industry are either small or, relatively speaking, young, and in any event less profitable than mature companies, stock and mutual alike. 1/

Simultaneously, Mr. Chairman, I recognize that in fashioning the Proposal you and Mr. Moore have been guided by an overall objective of adapting tax principles of general applicability to the taxation of life insurance companies; and that, if the resulting solution was conceptually sound, you would not feel constrained to ensure its consistency with any pre-conceived notion of "segment balance." Specifically, I understand that the original estimate was that the Proposal would yield revenue of approximately $4.5 billion, of which 47 percent would fall on the stocks.

1/ Much of the profitability of life insurance companies is attributable to ordinary life insurance business. The mutual segment of the industry continues to hold by far the lion's share of reserves attributable to ordinary life insurance. Data derived from the American Council of Life Insurance ("ACLI") Fact Book indicate that, for 1981, mutuals accounted for more than 65 percent of such reserves.

I note, therefore, that to the extent we have been able to re-estimate the impact of the Proposal, we believe that in its existing form it will raise between $4.2 and $5 billion, of which the stock segment's share would be between 37 percent and 40 percent. If this re-estimation proves to be accurate I hope, at the very least, that you will view with greater receptivity our position that an appropriate stock share of the aggregate industry burden is roughly 40 percent.

I trust, in any event, that the Subcommittee will better understand the basis on which we persevere in a sincere belief that a 40-60 balance is roughly appropriate. And we note, further, that to the extent that, starting from what is regarded as a conceptually sound basis for taxing the industry, the Subcommittee should decide to make concessions to the mutual companies, it would then become appropriate to give favorable consideration to making compensating adjustments for the stocks. This would assure that, having started from a sound conceptual foundation in the original Proposal as applied to both segments of the industry, no imbalance is created in the final outcome.

With these preliminary observations, I turn to a more detailed examination of the issues. The balance of this statement is divided into three principal sections. The first deals broadly with substantive company-level issues; the second with individual-level issues. In a concluding section I will discuss the matter of overall revenues.

I. COMPANY-LEVEL ISSUES

First I would like to discuss (1) the proposed taxation of mutual life insurance companies, (2) the proposed standards for measurement of life insurance reserves, and (3) options for dealing with the balance in the so-called policyholders surplus accounts under existing law.

Before turning to these issues, however, I wish to endorse the Proposal's suggestion that the limitation on deductibility of policyholder dividends and similar items not apply when such amounts are paid or credited by stock life insurance companies. This is clearly correct. Since benefits provided to customers (as distinguished from distributions to the owners of an enterprise) constitute costs of doing business, they should be deductible in determining net income subject to corporate tax. I also think the Proposal is correct in suggesting an amendment of the definition of a "life insurance company." This is a desirable change that will preclude some life insurance companies from securing the benefits of taxation under an entirely different regime by the simple elimination from annuity contracts of permanent annuity purchase rate guarantees.

We also endorse in concept the Proposal's special provision for the treatment of small life insurance companies. We do have some hesitation about the exact terms of the suggested approach, largely directed toward the apparent stringency of the eligibility rules and the precise magnitude of the special deduction. As far as we have been able to ascertain, only a small number of stock life insurance companies may benefit from the provision as it is now framed. I, therefore, urge that you give further consideration to the details of this special provision as described in the Subcommittee's Pamphlet. In doing so, the Subcommittee should keep in mind that the impact of any small company proposal along the lines set out in the Pamphlet would depend on the nature of the reserve system embodied in the ultimate version of the overall solution to the tax treatment of life insurance companies. We do have some concerns about the precise outlines of the reserve aspects of the Proposal, discussed more fully below. I simply note at this point that, were the Subcommittee to conclude that alterations in the proposed reserve system are warranted, that conclusion would affect the operation of any small company provision along the lines set out in the Proposal.

Finally, I note that the Proposal would modify the rules of existing law regarding the allocation of items of tax-exempt and tax-deductible income between a life insurance company, on the one hand, and its policyholders, on the other. According to the Pamphlet, the "policyholder's share" for this purpose "would include all amounts credited or paid to policyholders." I must confess that I do not fully understand the import of this suggestion, and we therefore request that clarification be provided.

A. The Taxation of Mutual Life Insurance Companies

The single most vexing aspect of taxing life insurance companies is deciding on the treatment to be accorded mutual life insurers. This issue has been problematic since the inception of our modern income tax and it is no less problematic now. We maintain that policyholders of a mutual life insurer do make an equity investment in the company, and that, like other investors, they earn a return on that investment. 2/ As the Proposal clearly recognizes, any sound solution to the taxation of life insurance companies requires that this "equity return" be taxed consistently with the treatment of equity returns from other corporate enterprises. The absence of such treatment would impose a significant competitive disadvantage on the stock companies with which the mutuals compete. Notwithstanding the arguments of mutual life insurers to the contrary, we thus believe it is essential that provision be made for taxing the equity return, 3/ which in turn dictates the need for a limitation on the

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2/ The views here expressed are consistent with those expressed in a paper entitled "The Equity Return to Mutual Life Insurance Companies and their Policyholders," submitted on behalf of the Stock Company Information Group to the staff working group on June 15, 1983. I will not reiterate in detail the discussion in that paper, but will be pleased to furnish a copy of it for the record.

3/ The mutuals continue to maintain that they are in effect "cooperatives" providing insurance "at cost." We note only that, even in the context of organizations that the Congress has explicitly exempted from tax because they are operated on cooperative principles, Congress has simultaneously seen fit to tax

(Continued on next page)

the deductibility by mutual life insurance companies of policyholder dividends.

In our view the magnitude of the equity return to mutual policyholders -- and the necessary limitation on the deductibility of dividends -- is undeniably substantial. We recognize, however, that measuring it with razor-like precision may not be possible. Thus, we acknowledge the difficulties in arriving at an ideally precise measure of policyholder earnings, and of an ideal limitation on the deductibility of policyholder dividends. Prior statutes, explicity or implicitly, prohibited mutual life insurers from deducting dividends against so-called "free" investment income. The Proposal adopts a different approach: It directly estimates the returns to equity of mutual life insurance companies, and prohibits any deduction for policyholder dividends against the equity return so estimated. The equity base is derived from N.A.I.C. "Annual Statement" data; the rate of return is based on a three-factor formula.

We endorse this aspect of the Proposal. Indeed, we pursued a similar approach in attempting to estimate the magni-

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their non-member income (such as portfolio income), even though it is applied to reduce the "cost" of supplying services to members. See, e.g., I.R.C. § 512(a)(3) (taxation of non-member income of social clubs); § 528(d) (taxation of non-member income from homeowners associations); cf. § 277(a) (disallowance of deductions by non-exempt social clubs for the cost of providing services to members against income received from non-members). Similar principles dictate that portfolio earnings of mutual life insurance companies, when applied to defray the cost of insurance by mutual policyholders, properly constitute "income," not a mere "reduction" in "cost."

tude of the equity return to mutual life insurers. The approach we pursued differs in significant detail from that embodied in the Proposal. And it was not clear to us that the approach we were pursuing was as readily susceptible to implementation as was the free investment income approach embodied in the law since 1921. Despite this, we think the approach embodied in the Proposal is generally workable and sound.

I must underscore, however, the importance of using rates of return in the general range yielded by the three-factor formula in the Proposal. I do so even though the mutual life insurers will surely assail the use of pre-tax rates of returns currently yielded by the formula on the order of 20-25 percent. Indeed, our own initial efforts to estimate the magnitude of mutual equity return significantly understated that return by employing rates derived from "safe" taxable securities, adjusted for anticipated corporate tax. That approach failed to incorporate returns to underwriting activities and yielded rates of between 15-20 percent in recent years, lower than the rates that appear to emerge from the three-factor formula in the Proposal. I point out, however, that our methodology was intended to be systematically conservative.

Moreover, our rates were applied to a mutual equity base that included an estimate of the "equity" in the business currently on the mutual life insurer's books. 4/ We assume that

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4/ That is, we attempted to estimate the value of the intangible, but nevertheless quite real, income-producing asset referred

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this element was excluded from mutual equity as computed in the Proposal for reasons of convenience. While we regard this omission as conceptually questionable, we understand why it was done. 5/ In our judgment, however, higher rates of return then become entirely appropriate -- indeed, essential -- when estimating the returns to the narrower, but more easily derived, equity base in the Proposal. Appropriately higher rates are yielded by the Proposal's three-factor formula.

The limited data currently available also suggest that larger, mature stock companies -- with which the mutuals might appropriately be compared -- experience pre-tax rates of return in the 20-30 percent range, in some instances even higher. Such rates are consistent with those that emerge from the Proposal. In short, I believe that rates of this general magnitude are essential to arriving at a realistic limit on the deductibility of policyholder dividends through the method the Proposal has set forth. 6/

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to as the "deferred" or "unamortized" acquisition expense attributable to policy acquisition costs. See The Equity Return to Mutual Life Insurance Companies and Their Policyholders, supra note 2, at 23-26, A1-A9. An estimate was necessary because such costs are required or permitted to be deducted currently for both tax and State regulatory accounting.

5/ Nonetheless, a very simple recognition of the unamortized acquisition expense component of equity could be prescribed statutorily as equal to some specified percentage of all commissions paid during the preceding 10 years.

6/ The dividend limitation, as we understand it, does not function as a true "minimum tax," as some mutual companies have as-

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I have several more specific observations on this aspect of the Proposal. First, efforts should be made to identify, and make provision for, areas in which the Proposal's dividend limitation might be manipulated. As the Proposal itself recognizes, one way in which this might occur involves the creation or use of stock life insurance subsidiaries of mutual life insurance companies. To foreclose mutual life insurance companies from using subsidiaries to circumvent taxation

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serted. As described in the Pamphlet, if the taxable income of a mutual life insurer before policyholder dividends proves to be less than the estimated equity return, then such lesser amount would be subject to tax. (See Pamphlet, at 9.) The effect of this aspect of the Proposal is to allow mutual companies to deduct "true" underwriting losses -- that is, losses not attributable to policyholder dividends -- against the "equity return." This feature of the proposal is appropriate, and consistent with historical treatment of life insurance companies, but renders the proposal something other than a "minimum tax."

At the same time, the mutuals assert the equity return concept should be applied as a "minimum tax" base for stock life insurance companies. While we have not yet been able to secure refined data, preliminary indications are that stock "equity return" -- derived by applying the methodology set out in the Pamphlet to a sample of stock life insurance companies -- would yield a tax base less than that anticipated under the general operation of the Proposal as applied to stocks, at least for the mature stock companies that are comparable to the large mutuals. For smaller companies, which typically experience underwriting losses, and even for those larger stock companies that are growing and hence are also experiencing underwriting losses, application of the "equity return" concept without allowance for the impact of "true" underwriting losses would be no more appropriate than it would be with the mutuals.

In any event, measuring the taxable income of a stock life insurance company does not present difficulties of the sort that are encountered with the mutuals, so that resorting to an "equity return" concept is not only inappropriate but wholly unnecessary in the case of a stock company.

of the mutual equity return, the Proposal provides that a life insurance company which is 80-percent owned by a mutual life insurance company would itself be subject to the mutual life company limitation on deducting policyholder dividends. While we believe this provision to be sound, it may not go far enough. We can envision circumstances in which one or more mutual life insurance companies might decide to do business through a subsidiary of which they owned less than the benchmark 80 percent, thereby avoiding the impact of the limitation on policyholder dividends, while still maintaining effective control of their business. I, therefore, urge the Subcommittee to consider reducing the control threshold from 80 percent to 50 percent, as well as to clarify that the test applies to one or more subsidiaries commonly owned by a consortium of mutual life insurance companies.

In a slightly different vein, it is possible that the provision for policyholder dividends payable in subsequent years, which under the Proposal is properly included in the mutual equity base, may be subject to manipulation. We understand the Proposal to include in mutual equity 50 percent of the provision for dividends that have been "apportioned" (line 7.1 on page 3 of the N.A.I.C. Annual Statement) and 100 percent of the provision for "unapportioned" dividends (line 7.2 on page 3 of the Annual Statement). But the extent to which the provision for dividends payable in subsequent years is treated as "apportioned" or "unapportioned," at least as we understand it, is largely within the discretion of the company. The opportunities for manipulation are obvious. I suggest the Subcommittee consider requiring the entire provision for dividends (or a very high percentage of the entire provision), apportioned and unapportioned alike, to be included in the equity base.

Yet another possible way in which the Proposal could be manipulated involves the definition of reserves that will be applied against mutual company assets to arrive at mutual equity. Mutual life insurance companies frequently hold additional, voluntarily created "contingency" reserves, designed to provide to their policyholders added assurances of solvency. Many of these reserves are not required by State-mandated "regulatory" accounting. Nevertheless, it is conceivable that the mutual companies might persuade State regulators that some of these voluntary contingency reserves -- which really are in the nature of "assigned" surplus -- should be required as a matter of State law. Such changes would operate to reduce mutual company taxable income without a corresponding reduction in "true" mutual equity. This possibility perhaps may be foreclosed by appropriate provisions in the definition of life insurance reserves that may be deducted for tax purposes, and by a further requirement that, in computing mutual life insurance "equity," only reserves that are deductible in computing taxable income may be applied against mutual assets.

I am confident that we have not exhausted the possibilities for manipulation. We have not explored, for example, the conceivably broad possibilities for manipulating "surplus" by means of reinsurance. Obviously, rules dealing with such matters must be finely crafted. We would be pleased to work with the Subcommittee and its staff in an effort to identify, and provide solutions for, these and other possible ways of circumventing the Proposal's dividend limitation.

We have one final reservation about this aspect of the Proposal. As the Subcommittee itself undoubtedly recognizes, the Proposal refrains from treating mutual earnings in a manner that is completely consistent with existing tax principles of general applicability. Although the Proposal ensures corporate-level taxation of mutual company earnings, it does not provide for taxation of earnings distributed to policyholders in their capacity as owners. As computed under the Proposal, pre-tax mutual earnings would constitute a non-trivial share of the typical mutual life insurer's statutory "gain from operations." And, since mutual companies tend to distribute a significant fraction of their gain from operations, the conclusion that they distribute a substantial share of their after-tax corporate earnings is inescapable.

The Proposal makes no effort to impose on these distributed earnings the equivalent of an individual or shareholder tax. We consider this a serious omission. We realize, of course, that taxing distributed earnings directly to the policyholders would entail practical complications, and also that imposing an additional tax on a mutual life insurer as a "proxy" for its policyholders would involve some difficulty in estimating the rates at which the amounts involved should be taxed. Nonetheless, the Subcommittee should be sensitive to the fact that this aspect of the Proposal has failed to tax mutual equity returns in a manner that is fully consistent with the treatment of returns to the owners of other enterprises organized in corporate form, including stock life insurance companies.

Nonetheless, we believe that, on this issue, the Proposal is generally sound. We endorse it, and we urge that it be made part of the Subcommittee's recommendations. We offer our assistance to the Subcommittee in refining the Proposal to strengthen it and to ensure that it is not enacted in a form susceptible to abuse. Sound implementation of this Proposal is essential to achievement of the Subcommittee's goal of providing tax equity between mutual and stock life insurance companies.

B. The Treatment of Reserves

The Proposal would allow companies a deduction in computing taxable income for the year-to-year increase in their reserves. However, it would require reserves to be computed on the most current interest and mortality assumptions permitted by applicable State law. In particular, the Proposal would require all reserves to be computed using a "full preliminary term" method. It would thus require the use for tax purposes of a "weak" first year reserve, in lieu of a full "net level premium" reserve; and, it also would require the difference between the weak first year reserve and the corresponding first year net level premium reserve to be amortized over the entire premium paying period of the contract. Under the Proposal, the deduction allowable to a company whose policy values exceeded its reserves, as thus defined, would be based on the cash values instead of the reserves. Further, reserves with respect to deferred annuity contracts would be limited to cash values even if the State-mandated minimum reserves were higher. 7/

I am cognizant of a skepticism about the desirability of allowing a tax deduction for reserve additions that are larger than the minimum actually required by State regulatory accounting. I realize there also exists substantial dissatisfaction with existing provisions that allow a life insurer to take a deduction on a "revalued," net level premium basis, for reserves which pursuant to State law are established using a weaker preliminary term method. In particular, I recognize the degree of concern with "approximate" revaluation under existing section 818(c)(2) of the Code. Nevertheless, I wish to make three basic points about this aspect of the Proposal.

7/ The Proposal thus would appear to allow no reserve deduction for those deferred annuity contracts, written primarily in connection with qualified pension plans, that have no cash surrender values.

First, the Subcommittee should recognize that the elimination of any preliminary term reserve revaluation will tend especially to disfavor small life insurers. The ability, under State regulatory accounting, to use preliminary term reserves is most important for small companies, whose surplus may be insufficient to fund full net level premium reserves or high cash values. And, notwithstanding your concerns about section 818(c), it was to equalize the reserve deduction allowable to such companies with that available to companies that could use full net level premium reserves that this provision was carried forward from the Revenue Act of 1942 into the 1959 Act.

Second, requiring the use for tax purposes of a "full" preliminary term method, together with a cash value floor, will needlessly complicate matters for both life insurance companies and the Internal Revenue Service. No company today may use a full preliminary term method in establishing N.A.I.C. Annual Statement reserves. Thus, separate reserve computations would be required for regulatory and tax accounting. This can be avoided by requiring the use for tax purposes of the Commissioners Reserve Valuation Method ("CRVM"), which is permitted by State laws or regulations, 8/ and which is also a recognized preliminary term method.

8/ While there are technical differences between "full" preliminary term reserves and preliminary term reserves using CRVM, in each case the difference between the first year reserve and the corresponding, first year "net level premium" reserve is amortized over the entire premium-paying period for the contract.

Our third reservation is one that you may not share, Mr. Chairman, but one that we nevertheless believe to be real. We are apprehensive that disallowing a Federal tax deduction for reserves computed on any basis other than State law minimums would tend to discourage life insurers from establishing their reserves for regulatory accounting purposes on any stronger basis. We do not assert that this will occur in all cases, and we are not able to quantify the possible impact. Nevertheless, we do have a concern that the reserve aspect of the Proposal may affect judgments about the level of reserves to carry, and over time will tend to cause companies to hold somewhat weaker reserves, thereby diluting their policyholders' assurances of solvency. There is, moreover, some concern among us that current minimum valuation standards are at an all-time relative weakness. Should events fail to justify the present optimism, it is likely that reserve strengthening will become necessary. Such reserve strengthening should be premissible for tax purposes if required by changing economic conditions outside the control of the company. Cognizable circumstances justifying reserve strengthening might include, for example, a decline in interest rates on new investments (or on the overall portfolio) to within one percent of those assumed in the reserve computations; or a decline in annuity mortality rates below those assumed.

We believe that the Proposal could be revised in a way that responds to this last of our reservations without doing violence to its basic objectives. Specifically, companies could be allowed to calculate their reserves for tax purposes using the same assumptions about mortality and interest that they use for regulatory accounting purposes.

Under our suggested alternative, life insurance companies would be required to use CRVM reserves for tax purposes. They would be denied any revaluation as under existing section 818(c). This would eliminate what, from the standpoint of Congress and the Treasury, is believed to be the most objectionable feature of the existing system of reserve computation. At the same time it would allow companies appropriate flexibility in setting up their reserves, and within that range of flexibility would permit them to establish their reserves without concern for whether a tax deduction would be allowable.

We recognize that to some extent our suggested alternative might be subject to manipulation. Specifically, companies that were particularly willing to assign a greater share of their surplus to reserves might be tempted to establish reserves on an extraordinarily conservative basis -- for example, by using unrealistically low interest assumptions -- in seeking an elevated tax deduction. 9/ In light of this possibility, if the Subcommittee were willing to consider an alternative of the

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9/ There are, of course, practical constraints on such activities. A reduction of surplus would make the company appear financially weaker, thereby reducing its attractiveness to policyholders.

sort that we propose, as we strongly urge it to, we would be happy to work with the Subcommittee in fashioning appropriate limitations on the reserve assumptions so as to ensure that the slightly more flexible solution that we propose is not susceptible to abuse.

Our suggestion would do no more than inject into the Proposal's basic framework a greater measure of reality as well as a slightly enhanced measure of flexibility. It would create, as would the Proposal, a fresh method of reserve computation for tax purposes that we believe is amply consistent with the Subcommittee's goals.

In return, we ask that the Subcommittee make the new reserve provision truly subject to a "fresh start". Specifically, we urge the Subcommittee not to adopt the reserve transition rule suggested in the Proposal, but simply to close out the books on preexisting reserves. It would be consistent with the initiation of a new, single phase tax to begin with a uniform reserve system that appropriately matches income and expense. The effect of this would be that deductions previously taken for reserves in excess of deductions on the new reserve basis would not be taken back into income. In defense of this outcome, we note that many stock companies never experienced a full decrease in tax from reserve revaluations under section 818(c). 10/ What is more,

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10/ For technical reasons, when an election was made to revalue reserves under section 818(c), the excess of the revalued re-

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under the Proposal (including the modifications we have suggested) a substantial number of mutual companies would never actually experience an increase in tax when prior reserve deductions were brought back into income. In light of these considerations, we strongly urge that the proposed "fresh start" with respect to reserves be made complete.

As a final matter, I note that the Proposal appears to deal rather fully with reserves under individual life insurance policies and annuities with cash values, but does not address the tax treatment of reserves for a variety of other products. Guidance is obviously needed regarding the treatment to be accorded Annual Statement reserves for such business lines as group life and health coverages, group pension, and individual non-cancellable and guaranteed renewable accident and health insurance. Consideration must also be given to reserves for supplemental benefits under individual life policies, such as guaranteed insurability and waiver of premiums. As in other respects regarding the tax treatment of reserves, we offer to work with the Subcommittee in the development of the appropriate tax rules.

C. Transition to 1984

To the stock segment of the industry, one of the most important aspects of implementing a new regime for taxing life

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serves over the statutory reserves in the year of the election never created a tax deduction, much less a tax benefit. Furthermore, reserve increases during a year in which a life insurance company incurred an operations loss that later expired unused likewise received no tax benefit from the increase in reserve.

insurance companies is the matter of transition to the new system. In the preceding section I discussed the matter of reserves. In this section I will discuss the treatment of previously deferred amounts.

Under the 1959 Act, the excess of "gain from operations" over "taxable investment income" experienced by stock life insurance companies, plus an additional $250,000, was subject to enumerated special deductions; and, of the balance of that excess, only 50 percent was currently taxed. The amounts allowed as "special" deductions, and the tax-deferred 50 percent of "excess" gain from operations, were applied to augment the balance of a "policyholders surplus account." Under rules specified in the statute, these amounts could be brought back into income at some future date or dates.

The Proposal does not suggest a specific treatment for existing balances in the policyholders surplus accounts. It does point out that the Subcommittee "may wish" to tax "amounts currently in the policyholders' surplus accounts", and it goes on to describe options that "may be considered" by the Subcommittee if it elects to pursue this course. (Pamphlet, at 13.)

When all is said and done, the Subcommittee is considering enactment of an entirely new system of taxing life insurance companies, one which the stock segment of the industry is largely prepared to endorse. It would be consistent with these objectives simply to eliminate the preexisting balances in the policyholders surplus accounts, thereby creating a "fresh start" for the new system. What is more, there are substantial conceptual and equitable arguments to be made in behalf of doing so, and we urge the Subcommittee, as part of its final recommendations, to adopt that course.

There are essentially two arguments to be made in behalf of eliminating the existing balances in the policyholders surplus accounts. The first is based on a comparison of the treatment of the mutual life insurance companies under the 1959 Act and under the Proposal. The second is based on the result when, as part of the "stopgap" provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), section 820 of the Code was repealed.

As to the first, the Subcommittee should recognize that the entire balance in the policyholders surplus accounts is roughly attributable to items of deduction or deferral taken against underwriting income -- specifically, against the excess of stock life insurance companies' 1959 Act "gain from operations" over their 1959 Act "taxable investment income," plus the additional $250,000 amount. 11/ The Subcommittee should simultaneously recognize that, under the 1959 Act, mutual life insurers were allowed to deduct policyholder dividends -- whether derived from underwriting gains or investment gains -- against the

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11/ Under TEFRA, some amounts in excess of $250,000 were allowed as a deduction against taxable investment income.

excess of their gain from operations over their taxable investment income (plus $250,000) without limitation, and without any provision for these items to be restored to income at any time. In effect, none of the mutuals' underwriting income was taxed, while a portion of the stocks' underwriting income was currently taxed and the balance allocated to the policyholders surplus accounts.

The Proposal's suggested treatment of mutual life insurers implicitly recognizes that the treatment conferred by the 1959 Act on mutual life insurance companies was unduly generous. That Act failed to tax the mutuals or their policyholders on earnings attributable to underwriting gains. The Proposal, if properly implemented, would rectify this omission. But the Proposal makes no effort to "recapture" any earnings that arose under prior law attributable to underwriting gains, even though the failure to tax those gains, when earned, was conceptually wrong. Since the current balances in the policyholders surplus accounts are the tax-deferred counterparts of items that never were, and never will be, taxed to the mutuals, consistency suggests that it would now be unfair to tax them to the stocks.

Secondly, the Subcommittee should recall that, as part of the congressional decision to eliminate section 820, Congress refrained from attempting to tax the benefits secured through the use of so-called "modified coinsurance" during the period 1979-82. The very substantial benefits realized through these arrangements accrued very largely to the mutuals. It would not be even-handed to forebear from recapturing past "modco" benefits, which accrued largely to the giant mutuals, and then proceed to exact the last dollar deferred under the provisions of the 1959 Act from the stocks.

These considerations would amply justify a decision by the Subcommittee to forebear from taxing the existing balances in the policyholders surplus accounts. We therefore urge that the Subcommittee adopt this course. If, on the other hand, the Subcommittee should decide not to do this, we ask that it preserve the rules embodied in the 1959 Act itself. The new system outlined in the Proposal, in whatever the precise form it ultimately emerges, will radically alter, and in many ways make more stringent, the system for taxing stock life insurance companies. Developing a familiarity with the operation of the new system will take time. In this context, adopting a new set of rules for taxing the accrued balances in the policyholders surplus accounts would require further operating adjustments. And it would serve to make the burden on stock companies even more substantial than it otherwise would be, seriously threatening the financial stability of small, and even of some larger, companies.

In sum we urge the Subcommittee to give sympathetic consideration to closing out the existing balance in the policyholders surplus accounts. Doing so would be justified by substantial equitable considerations, and would be consistent with the Subcommittee's objective of achieving a fresh start in the taxation of life insurance companies and their policyholders. If the Subcommittee is unwilling to adopt this approach, then the only acceptable alternative is preservation of the rules of the 1959 Act.

II. INDIVIDUAL-LEVEL ISSUES

A. Definition of Life Insurance

The Proposal suggests a number of changes in the taxation of individuals under various insurance products and transactions. First among these is a permanent extension (with significant alterations) of the temporary "guidelines" for flexible premium life insurance policies to all life insurance products. Under the Proposal, section 101(f) of the Code, enacted last year in TEFRA but then limited to universal life and adjustable life policies, would be altered and broadened to encompass all types of life insurance policies, providing the first comprehensive Federal income tax definition of "life insurance." Unless a policy that was treated as life insurance under State law also complied with one of two statutory tests -- a "guideline premium limitation" (with a minimum risk "corridor" requirement) or a "cash value" test -- the tax treatment historically applied to life insurance policies and their benefits would be unavailable. Any non-complying policy would be treated for tax purposes partly as providing term life insurance and partly as establishing a premium deposit fund or other accumulation account, the interest on which would be currently includible in the policyholder's gross income.

Stock life insurance companies, which recently have brought to the life insurance marketplace a number of innovative products, strongly support the notions (1) that there should be a statutory Federal income tax definition of "life insurance," and (2) that such a definition should embody the dual, alternative tests first introduced in TEFRA. The enactment of a definition of life insurance for tax purposes would serve to limit the favorable tax rules respecting life insurance benefits to those contracts which provide for legitimate protection needs, would exclude a number of contracts that are more properly described as investment vehicles, and would particularly exclude those contracts of more recent vintage that have been designed to lay claim to life insurance tax treatment despite their heavy investment orientation. We share the Government's concern that a tax definition of life insurance is essential to preventing abuse of the tax system.

I underscore that, in our view, the Proposal has rightly suggested that the dual, alternative tests of TEFRA be embodied in the new tax definition of life insurance. Both the guideline premium test, described in the Proposal as Alternative 1 (sometimes also referred to as Test A), and the cash value test (Alternative 2 in the Proposal, also known as Test B), appropriately serve to preclude undue investment orientation. From the standpoint of the Government, therefore, the one test should be viewed as the equivalent of the other. Stock companies consider it critical that, consistently with the Proposal, both these tests be included in the definition.

No doubt you have heard, and will continue to hear, complaints from quarters within the industry that the only basis for qualifying as life insurance should be the cash value test. Such complaints emanate from those whose interests include reducing competition within the industry, particularly competition from newer product forms. I am confident that this Subcommittee would not wish to sanction efforts of this sort. Nonetheless, I think it appropriate at this juncture to reaffirm why we believe the Proposal is correct in including the guideline premium limitation as one of the definitional tests.

The guideline premium test of TEFRA responds properly and sufficiently to Government concerns that undue investment orientation be precluded in a product that is treated for tax purposes as life insurance. What is more, it does so without imposing all the product design limitations inherent in a cash value test. Simply put, the guideline premium test limits the amount of premium that may be paid for a life insurance contract to a gross premium that might be charged for that contract, based on the contract's underlying actuarial assumptions. In this fashion the test precludes investment orientation in a contract which it governs; the test sends a message, in effect, that those seeking an investment vehicle should go elsewhere to invest their wealth. This, we submit, is the most explicit means available to assure that contracts taxed as life insurance are not oriented primarily toward investment. In our view an individual seeking to make an investment, rather than to purchase insurance, would find it simply unattractive to purchase a contract subject to the restrictions of the guideline premium test.

To be sure, the cash value test also limits the investment orientation of a policy. Rather than circumscribing the amount of premium, however, it focuses exclusively on the pattern of available values that develops under a policy, and on the relationship of that pattern to the death benefit. To satisfy the cash value test, the actual cash values of a policy must, at most, track the pattern of cash values -- per thousand dollars of death benefit -- under a traditional, fixed-premium whole life insurance policy. In short, the cash value test posits that whole life insurance is the "norm," the model to be followed. In this fashion the cash value test also responds to the Government's legitimate concerns.

The guideline premium test should be preserved precisely because, like the cash value test, it addresses all legitimate Government concerns while simultaneously providing maximum flexibility in life insurance product design. This will inure to the ultimate benefit of consumers of insurance. The cash value test, if permitted to stand as the sole test of "life insurance" for tax purposes, would force all products into the mold of whole life insurance. To mandate that outcome as a matter of tax policy would be unfortunate, unnecessary, and contrary to the interests of the public. In particular, it would impair the market viability of newer forms of life insurance products with flexibility in premiums and benefits, products which have been designed to fulfill the insurance needs of consumers in the 1980s. While whole life insurance has served the needs of the public in the past and will continue to play an important role in the insurance marketplace, it is by no means the only serious player in that market in 1983, and it would serve no legitimate purpose to compel all other insurance products to parrot whole life. For these reasons, while we believe the cash value test has a place in the new definition of life insurance, we believe that place is alongside the guideline premium test.

Given the propensity of the cash value test to force all products it governs into the mold of whole life insurance, one can readily see why those who desire to limit competition from non-traditional policy forms are the ones who propose it as the exclusive test. In this respect, I would emphasize two points. First, contrary to assertions that the "battle" over the guideline premium test is merely another aspect of the disagreement between the stock and mutual companies within the industry, you should be fully aware that a number of mutual companies -- those selling non-traditional product forms --

share our concerns about having a cash value test as the sole statutory rule. To prescribe cash value as the only test for life insurance would not only bias the tax law in favor of mutual company policy forms and against stock company policy forms, but would also broaden that bias in a way that impairs the non-traditional policy forms of certain mutual companies.

Second, with the alternative tests embedded in the statutory definition of life insurance, we believe that traditional and non-traditional products will be able to compete on an equal footing. While the guideline premium test as enacted in TEFRA may permit the cash value element to be greater for some later durations (in relation to a given death benefit) than would be true under the cash value test, for many durations the guideline premium test is actually more restrictive. This is particularly true in the early years of a policy, when someone interested in making an "investment" would most be discouraged by the low dollar limit imposed by the guideline premium test. Such additional restrictiveness arises from the fact that the TEFRA guideline premium limitation applicable in a policy's early years is based on a 6 percent minimum interest assumption, while the cash value test of TEFRA employs a minimum interest assumption of 4 percent. (The higher the interest assumption, the lower the resulting premium or cash value.) Thus, whereas a 4 percent premium could be charged for a contract governed by the cash value test (roughly $350 to $400 per $1,000 of death benefit for a 35-year old), only a 6 percent premium, which is much smaller (about $170 per $1,000), could be accepted under the guideline premium test. There is, in other words, a "trade-off" within the guideline premium concept.

Overall, then, a policy relying on one test is not inherently advantaged or disadvantaged as compared with a policy relying on the other test. It may well be that companies issuing flexible premium or benefit policies will tend to rely more on the guideline premium test, and that writers of fixed-benefit contracts, who can afford to rely on the cash value test because of the fixed nature of their products, will tend to utilize that test instead. But this should not be troubling. The simple point is that, in the flexible product case, the premium limit approach has a logical appeal while also according the purchaser (or prospective purchaser) the appropriate threshold certainty regarding the premium and benefit patterns -- provided the up-front liberality of the cash value test is sacrificed.

With these concerns expressed, which I have set forth to underscore the reasoned basis for the Proposal's concept that the definition should encompass dual, alternative tests, I now turn to our concerns with specific elements of the definition, as outlined in the Proposal. These concerns emanate from the fact that certain of the elements of the suggested definition -- particularly insofar as they depart from the rules developed in TEFRA -- display a pronounced bias in favor of the product forms traditionally written by mutual life insurers and a bias, therefore, against those product forms that would be their competitors. We maintain that it is essential to correct this bias.

The Proposal, in its specific suggestions, would work four changes from the TEFRA rules: (1) the single premium rule under both tests would be replaced with a "10-pay" rule, albeit with a special relief provision for single premium paid-up additions; (2) the minimum risk "corridor" associated with the guideline premium test would be altered to increase greatly the minimum death benefit required in relation to the cash value of a policy; (3) a contract with a value structure aimed at maturity or endowment before age 95 would be made to fail the test; and (4) a pattern of premium payments or cash values that would fully fund a contract with scheduled increasing death benefits (however small the increase) would likewise be caused to fail the test.

On each of these particulars, we frankly and sharply part company with the Proposal. Moreover, we believe that stock companies are joined in this position by those mutual companies that write non-traditional flexible premium and benefit policies.

(1) 10-Pay Rule. As enacted in TEFRA, both the guideline premium test and the cash value test permitted a life insurance policy to be purchased with the payment of a single

premium. Such a rule, since it was stated as a maximum, preserved considerable flexibility for both the policyholder and the issuing company while still assuring the Government that a policy would be purchased for its insurance rather than its investment features. The Government was assured of this by virtue of the fact that the single premium historically was the most that any individual could or would pay for a life insurance contract upon issue; the payment of a greater amount indicated that an investment was being placed with the insurer rather than that insurance protection was being purchased. This assurance manifested itself concretely in the numbers involved: Under the guideline premium test, the single premium for a 35-year-old insured amounts to about $17,000 for a policy with a level death benefit of $100,000. In such a case, by requiring that at least $83,000 of "pure" insurance protection be purchased in connection with the payment of the $17,000 premium, the test seems to us to provide the Government with all the assurance it needs that an investor would shun any contract governed by the test. The adoption of any further restrictions, such as the 10-pay rule, would only serve to bring the Federal Government into the business of regulating insurance policy design, and for reasons not justified by tax policy concerns.

Whole life policies issued by mutual insurers would generally be able to thrive within the confines of the more restrictive rule; particularly in that the 10-pay cash value test suggested in the Proposal would carve out a special niche for single premium paid-up additions purchased with dividends under participating whole life policies. No similar specialized relief is provided under the guideline premium test. This would serve to favor the traditional mutual company product, which would utilize the cash value test, at the expense of, and to the detriment of, every other product. The paid-up addition carve-out also raises an even more fundamental question: If a 10-pay rule is really necessary to prevent investment orientation in a contract, why is this not also true for each unit of insurance known as a paid-up addition? A unit of insurance is a unit of insurance, whether it is provided as a basic death benefit under a policy or as a paid-up addition. The special carve-out truly underscores the excessively restrictive nature of the suggested rule, as well as its express bias in favor of the traditional mutual company product form.

The use of a 10-pay rule would pose still other difficulties. Suppose an insurer sought to upgrade policyholder benefits (comparably to the "update" activity undertaken by a number of mutual companies in recent years) by offering to exchange a newer policy form for one of its traditional contracts that had been in force for a number of years. This simply could not be done under a 10-pay rule, since the cash value of the existing policy would exceed the maximum first-year premium or cash value permitted for the new policy under the suggested rule. To us, this demonstrates that the adoption of a rule more restrictive than a single premium rule would prove to be unwise (as well as unnecessary). I therefore strongly urge this Subcommittee to return to the single premium rule that was successfully used in TEFRA, a rule which is surely adequate to police against investment orientation in life insurance contracts.

(2) Enlarged "Corridor". The Proposal also suggests that the guideline premium test's minimum risk "corridor" as enacted in TEFRA be greatly expanded. The TEFRA corridor -- which required a minimum death-benefit-to-cash-value ratio of at least 140 percent through the insured's age 40, declining 1 percent each year thereafter until the ratio reached 105 percent at the insured's age 75 -- would be raised to a minimum ratio of 250 percent through age 40 and would then decline by 4 percent each year (until it "levelled off" at 110 percent, at age 75). This amounts to a tinkering with the statutory scheme for no apparent purpose other than to impose on those policies that otherwise would be governed by the guideline premium test the product design restrictions of the cash value test. This move is most unwise and we strongly oppose it.

Today's innovative product designs, which are typically characterized by flexibility in premiums or benefits (or both), simply cannot function properly or retain their marketability if they are forced into the mold of whole life insurance, a result which inevitably follows from the cash value test. If the guideline premium test's "corridor" is arbitrarily rearranged to impose a parallel with the cash value test's required benefit pattern, these innovative products would have an equally difficult time surviving under the guideline premium test. A re-design of the "corridor" to require the provision of enlarged "pure" insurance benefits, particularly at later ages, would inject great uncertainty into either or both of the premiums that may be paid under a flexible premium contract or the level of coverage that may be issued. This would competitively disadvantage the newer product forms as against whole life insurance, which no doubt would be portrayed in the marketplace as operating in a much more certain world.

There is also one other point to be made. As I previously noted, the guideline premium test (including its "corridor" component) was framed as a "trade-off," permitting the payment of a substantially lower premium than the cash value test would permit in return for which the crediting of excess interest -- necessarily unknown in amount at the inception of a policy -- would be disregarded for tax purposes except as to an overall minimum risk requirement. If the "corridor" were enlarged, ostensibly to force a parallel with the cash value test, this would mean that less premium could be accepted than under the cash value test even though the risk assumption required would be about the same (or possibly greater). This would be purposeless as well as unfair.

(3) Maturity or Endowment Date. Since the inception of the modern income tax in 1913, insurance contracts known as "endowments" -- those which provide for the payment of their cash value if the insured is living at the expiration of a specified term, e.g., when the insured reaches age 65 -- have always been treated for tax purposes in the same manner as all other life insurance contracts. The death benefit under an endowment contract clearly involves the issuing company's assumption of a substantial pure insurance risk until shortly before the date of endowment. The endowment benefit, when paid, is subject to tax. Endowment contracts have traditionally been employed to fulfill an accumulation function (such as for retirement) alongside the provision of life insurance coverage, and while such contracts have not been sold with great frequency in recent times of unstable interest rates, many insurers believe that there will again be a significant market for these policies when there is a return to a more stable economy.

The Proposal, unfortunately, would foreclose endowment contracts from being written in the United States. Such contracts could not be adequately funded since the tests under the Proposal would be required to assume that the maturity or endowment date does not fall before the insured reaches age 95 -- meaning that the level of premium needed to endow the contract before age 95 simply could not be paid in without entailing a violation of the tests. Moreover, since the failure of a contract to meet one of the Proposal's tests would result in "side fund" treatment of the contract's cash value as it builds up, the endowment contract as traditionally written would become wholly unattractive and unsaleable.

This, we think, is an unnecessarily harsh result. We therefore urge this Subcommittee not to endorse the maturity date restriction suggested in the Proposal. We believe it would be sufficient simply to require that, for purposes of the new statutory tests, the maturity date be taken to be not earlier than the latest date permitted under the contract, though with some minimum required endowment period.

(4) Death Benefit Pattern. The final change that the Proposal would make in the TEFRA rules would be to forbid, for purposes of computing the premiums and cash values under the tests, the recognition of a scheduled pattern of increasing death benefits. We think that this also is too harsh. For many years a number of policies have provided for increasing death benefit patterns. Such policies include those with cost-of-living escalators, return-of-cash-value provisions, and rights to purchase single premium units of insurance (encompassing paid-up additions). These policies, which respond to needs for growing levels of insurance coverage in light of inflation, greater income to protect, and so forth, should not be discouraged. Admittedly, some reasonable limits must be placed on the degree of "pre-funding" of such benefits, lest there again be possibilities of investment

orientation. There are no natural limits here, however, meaning simply that a line-drawing exercise must be undertaken. We think it would be reasonable, and responsive to Government concerns, at least to permit a continuation of the TEFRA rules regarding increasing benefits. These rules would allow the pre-funding of a return-of-cash-value policy and of at least a portion of the future benefits under a policy providing for cost-of-living increases.

In sum, we urge you not to adopt any of the four specific changes suggested in the Proposal, and we recommend instead a return to the rules of TEFRA. Those rules provide fully sufficient assurance that the contracts subject to them will not be investment oriented, while preserving, particularly under the guideline premium test, maximum flexibility in life insurance product design. Clearly, we think, this should be Government's goal in defining life insurance for tax purposes -- neither more nor less. The four specific changes listed in the Proposal stray from this goal and, insofar as they do so, they should not be written into the new statute.

B. Deferred Annuities

The Proposal would alter the rules, enacted just last year in TEFRA on a "permanent" basis, governing the treatment of premature distributions under nonqualified deferred annuity contracts. Specifically, the Proposal would apply IRA-type rules to nonqualified deferred annuity distributions, requiring distributions to begin once the annuitant reaches age 70-1/2 and penalizing distributions made before the annuitant reaches age 59-1/2 (except in certain instances). In this fashion, the Proposal would depart from the TEFRA rule providing that the penalty would "wear off" with respect to premiums that have remained in the contract for more than 10 years, and it would depart as well from the TEFRA penalty exception in the case of equal periodic payments for life or for at least 5 years (the Proposal would substitute 10 years). Also, the Proposal would, for the first time, impose upon nonqualified annuities a distribution requirement related to the annuitant's age.

These suggested changes simply are not needed. In our view, TEFRA adequately dealt with the tax policy problems connected with premature distributions from nonqualified deferred annuity contracts. Further tampering with the TEFRA changes, which have already had great impact in the annuity marketplace, would amount to "overkill". We assume that the importation of the IRA rules into the nonqualified deferred annuity area had its genesis in a desire to conform the two sets of tax rules. While there may be a superficial appeal in the IRA analogy, the two situations are not at all closely related. In the case of an IRA, it must be remembered, the taxpayer is accorded a deduction from gross income for the amount of the premium he has deposited. The nonqualified annuity, on the other hand, is purchased with tax-paid dollars. This is a crucial distinction which, although frequently overlooked in debates of tax theory, is of real practical import that must not be overlooked.

We had been under the impression that the tax policy problems of deferred annuities had been "solved" by TEFRA, and we thought that the Government agreed with this view. We were, therefore, frankly surprised to see this matter raised again in the Proposal. We strongly suggest to this Subcommitte that you permit the TEFRA rules to remain in place and that, at some later date, you check on their sufficiency. At this stage, no reason has been suggested to us, and none occurs to us, to go any further.

C. Policyholder Loans

Life insurance policies are required by State law to include provisions permitting policyholders the right to borrow up to the amount of the cash surrender value on the sole security of their policies. Particularly in recent years, sizeable amounts have been borrowed from life insurance companies pursuant to these provisions. The companies, by contract, charge their policyholders with interest on these loans, and such interest has generally been treated as deductible in determining a policyholder's taxable income. This deduction is provided under section 163 of the Code, as modified by the restrictions found in section 264 of the Code. The Proposal would place a further restriction on policy loan interest deductibility: Interest attributable to loans in excess of $50,000 (per taxpayer) would no longer be deductible. The Proposal would impose this new rule on existing as well as future policies, though only with respect to future loans.

We understand that individuals within the Government have for some time been concerned with the deductibility of interest paid on policy loans, though we do not believe this concern has been directed particularly toward borrowing practices under policies issued by stock life insurance companies. We have three specific reactions to the Proposal in this regard.

First, we do not understand why a $50,000 limit, as a particular figure, commends itself. While the figure may have been transported from rules enacted under TEFRA for loans from qualified pension plans, we note that the tax considerations relating to such plans are quite different from those relating to life insurance policies, and we do not see the analogy.

Second, it strikes us as unfair to apply the suggested rule to borrowings against life insurance policies already in force. While we realize that no taxpayer can claim a vested interest in the tax rules existing at the time he or she entered into a particular transaction, we think that considerations of equity and fairness suggest that the transitional rule employed here (if there is to be a change) should conform with the rules applied to prior amendments to section 264. Specifically, it would make more sense to apply any new policy loan interest restriction only to loans taken under policies issued after the new rules take effect.

Third, and finally, we urge you to listen to the concerns that will be expressed in regard to this matter by other witnesses you have invited to appear before you today.

D. Computation of Investment in the Contract

Under existing tax rules, upon the surrender or maturity (other than by death) of a life insurance policy or endowment contract, the policyholder is considered to have income in the amount by which the cash or endowment proceeds of the contract exceed the amount paid for the contract, *i.e.*, the aggregate of the gross premiums reduced by any returned premium. This rule, which may be viewed as of general application, is simple and readily administrable and has, accordingly, worked well over the years. The Proposal, however, would change all this by requiring that, for purposes of computing the amount includable in gross income upon a surrender (or upon a partial withdrawal), the aggregate premium figure be reduced by the mortality costs specified or implicit in the contract.

We urge you not to adopt this suggestion. We doubt that this aspect of the Proposal has much to commend it. It is conceivable that it might produce some slight revenue gain in the long run, but it will complicate matters and will entail substantial costs to administer. While we have not been able to perform the computations, we question whether the possible individual revenue gain arising from adoption of such a suggestion would exceed the decrease in corporate tax otherwise collectible from life insurance companies because of the expense the companies will incur in administering this change. This suggestion, far from simplifying the law, would add complexity for no very good reason.

III. IMPACT, REVENUE AND THE TAXABLE INCOME ADJUSTMENT

Overall the revenue to be raised by the Proposal in its existing form, as best we can estimate it, is approximately $5 billion in 1984. 12/ This amount is the result of the application to life insurance company taxable income, as determined under the Proposal, of a percentage deduction or "taxable income adjustment" ("TIA") of 25 percent.

As I already have indicated, the stock segment share of this projected total revenue would be on the order of $1.8 billion for 1984. This is roughly a 50 percent increase in total tax over the amount that stock companies would have paid under the 1959 Act in 1984, and at least a doubling of the tax estimated to be produced in 1984 if the temporary provisions of TEFRA were extended. In an effort to assess the impact of the Proposal on specific companies, I asked the members of the Stock Company Information Group to provide me with estimates of the change in their respective tax liabilities in 1982 had the Proposal been in effect for that year. The data provided by these companies show, in some cases, a tax increase of 10-25 per-

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12/ Based on American Council of Life Insurance estimate dated July 22, 1983.

cent; in other instances, a doubling of tax or more; and, in still others, a significant reduction in operations losses or a conversion of losses into income, producing positive tax liabilities. No company experienced a decrease in tax.

While I realize that revenue considerations must be placed in the larger overall context of Federal tax and budget policies, several comparisons suggest that the revenue produced by the Proposal in its existing form is substantially too high. It is too high by comparison with the tax burden imposed on other financial intermediaries with which life insurance companies compete. And it is too high in historical context.

While accurate comparisons are hard to draw, it is widely understood that other financial intermediaries are taxed on an extremely favorable basis. For example, as recently estimated by the Joint Committee on Taxation, commercial banks currently are subject to an effective U.S. tax rate on U.S. income of approximately 2.3 percent. While, because of the financial difficulties they have experienced in recent years, it is difficult to compute effective tax rates for savings and loan associations, I note that they are subject to the special "bad debt" deduction of section 593 of the Code amounting to 40 percent of otherwise taxable income. Such considerations, which we will be happy to refine if you desire, suggest in a rough way that the burden that would be imposed on the life insurance industy by the Proposal is out of line with the taxation of other financial institutions.

Looked at in wider historical context, the burden that would be imposed by the Proposal is extraordinarily high. Based on ACLI data, the 1959 Act imposed on the industry tax liabilities which, during the 20 year period 1959-1978, ranged from a low of 2.4 percent (in 1959) to a high of 4.5 percent (in 1975) of the total Federal corporate income tax. Over the past several years, however, Congress has enacted legislation, particularly but not exclusively the accelerated cost recovery provisions of the Economic Recovery Tax Act of 1981, which has operated to reduce the tax liabilities of the non-financial corporate sector. The interaction of the Proposal, in its existing form, with such other tax law changes would mean that, in 1984, the life insurance industry would account for approximately 8.75 percent of the entire corporate income tax, nearly twice the highest share yielded by the 1959 Act. 13/ Even if the 1984 revenue from the proposal were reduced to $2.5 billion, the 1984 life insurance company share of aggregate corporate tax liability would be nearly 4.6 percent, 14/ still higher than the greatest percentage share yielded by the 1959 Act.

We think it inappropriate to fix tax burdens on the life insurance industry without regard for the general trend

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13/ Based on a $5 billion estimate of 1984 revenue from the Proposal, and a 1984 estimate of corporate sector tax liability (excluding life insurance companies) of some $52.25 billion. These estimates are based on ACLI data.

14/ Based on the same ACLI data.

of corporate taxation. In its existing form, however, that is exactly what the Proposal would do. Thus, we believe that, after having settled on the substantive elements of the Proposal, there is a compelling need to adjust the overall revenue. This, we believe, could best be accomplished by a change in the taxable income adjustment, which would alter the amount of revenue produced without altering the distribution of the impact on the industry. We believe such an adjustment to be essential.

CONCLUSION

Mr. Chairman, as I said at the outset I am grateful for this opportunity to testify. As you can see, we have some reservations about the Proposal. But, as you can also see, it is our view that with refinements the Proposal can indeed create a new framework for taxing life insurance companies and their policyholders. We commend you and your colleagues for what you have achieved thus far. We offer you our complete cooperation as you proceed toward the culmination of your efforts.

Respectfully submitted,

Hartzel Z. Lebed

THE EQUITY RETURN TO MUTUAL LIFE INSURANCE COMPANIES AND THEIR POLICYHOLDERS

This paper considers what, in the current episode of the perennial tax debate between stock and mutual life insurance companies, has come to be called the "ownership differential."

The policyholders (or customers) of a stock life insurance company are distinct from its owners. The tax treatment of benefits provided by a stock life insurer to its customers generally calls for entity-level deductibility and for deferral or exemption to the policyholder. The treatment that generally governs the net earnings of corporate enterprises (including stock life insurers) calls for current corporate-level taxation; and a second, separate round of shareholder-level taxation when earnings are distributed.

A mutual life insurer, on the other hand, has no owners other than its policyholders. Restated, then, the issue posed under the rubric of "ownership differential" is really whether the values transferred by a mutual life insurer to its policyholders systematically include some element that properly may be said to constitute an "ownership return" or "equity return" (and properly should be taxed as such). This terminology will be used throughout the balance of this paper.

Section I reviews several arguments advanced in support of the proposition that the equity return to mutual life company policyholders either is very small; or that, under existing law, it is treated for tax purposes in a manner consistent with the taxation of returns to stock companies and their shareholders. Section II then describes the financial considerations which suggest that mutual life insurance policyholders do indeed make an investment in the company on which they receive an equity return.

Is the equity return to mutual company policyholders of sufficient magnitude to warrant congressional concern? Section III develops a procedure for estimating the equity return. This is not the only procedure that might be employed, though it seems to us the most promising. Section IV summarizes the results of this estimating procedure for a sample of years since 1959.

I. Arguments Against the Existence of an Equity Return

One of the witnesses invited by the Subcommittee on Select Revenue Measures to the May 10, 1983, hearings was Dr. Norma Nielson. Although Dr. Nielson recognized that a "theorectical basis does indeed exist for a portion of the" mutual policyholder "dividend payment being considered a return on investment," */ she then described a procedure by which she concluded that the untaxed equity return in dividends paid by mutual life insurers to their policyholders, in the aggregate,

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*/ See testimony of Norma L. Nielson, Ph.D., at 7.

is negligible. While it is not clear precisely what Dr. Nielson's methodology was, as best as we understand it, it proceeds from a premise that is flawed.

Evidently, Dr. Nielson began by assuming that a mutual life insurance company would be "paying out amounts which are either a return of investment and/or a return on investment" only in a year in which it paid dividends and experienced a "decrease in surplus." */ Dr. Nielson testified that, after examining the 1980 balance sheets of 1661 life insurers, she could identify only eight mutual companies which both paid dividends and experienced a decrease in surplus. (The eight firms were not named.) Adopting the assumption that 50 percent of the dividends paid by those companies constituted "a return on investment," Dr. Nielson concluded that only $21 million of equity return would go untaxed if such dividends were fully deductible.

Dr. Nielson's methodology appears to equate "return of investment" with "return on investment." By narrowing the field to companies which both paid dividends and experienced a decrease in surplus, Dr. Nielson entirely eliminated mutual life insurers whose pre-dividend gain from operations was sufficient to allow them both to pay policyholder dividends and to augment their surplus. Such companies may well have been making

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*/ Ibid.

distributions out of current, as well as accumulated, gain. Thus, even though Dr. Nielson concluded that the untaxed equity return to mutual policyholders is negligible, we respectfully submit that the methodology by which she reached her conclusion is not sound, and that the conclusion is unreliable.

A second argument advanced by mutual life insurers is that, even if equity returns are earned and distributed by a mutual life insurer to its policyholders, exempting such returns from tax is conceptually sound. The premise of this argument is that contributions to the capital of a stock life insurance company, on which a return is paid, are received tax-free by the company. In contrast, so the argument goes, equity contributions supplied to a mutual life insurance company by its policyholders are taken into income as they are received, and therefore are currently taxed. */ The argument proceeds to suggest that taxation of contributions to the capital of a mutual life insurer is the financial equivalent of taxing the returns to equity in a stock life insurance company. The argument concludes that since mutual life insurers are taxed on their receipt of equity capital whereas stock life insurers are not, and since stock life insurers are taxed on corporate level

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*/ This argument is most fully articulated in a paper, dated January 12, 1983, authored by Theodore R. Groom of Groom & Nordberg and Matthew Zinn of Steptoe & Johnson (the "Zinn-Groom Paper"). The theme was echoed by the Mutual Company Executive Committee witnesses at the May 10 hearings.

earnings whereas mutual life insurers are not, the treatment of the two is equivalent.

While this point is an intriguing one, in practical application it breaks down. First, stock life insurance company earnings are subject to corporate-level tax and then to shareholder-level tax on amounts distributed as dividends. Even in theory, the "equivalence" argument applies only to the corporate tax. Second, the argument is without practical merit insofar as the capital base of a stock life insurance company consists of retained corporate earnings, which already have been subject to the corporate tax, rather than paid-in capital that was received tax free. As with other enterprises, moreover, previously taxed earnings loom large in the typical stock life insurer's capital base. Thus, insofar as the foregoing argument contends that equity returns to a mutual life insurer must be exempted from tax in order to place mutuals in the same position as stock life insurers who receive paid-in capital free of tax, it may hold only with respect to returns attributable to the relatively small paid-in capital element.

Finally, and most fundamentally, the premise that mutual life insurers are actually taxed on amounts contributed to their capital through policyholder premiums flounders on the historic and current reality of mutual company taxation. From 1921 through 1957, mutual companies were taxed only on their free investment income. No effort was made to tax premium receipts. From 1958 through the effective date of the 1982 "stopgap" legislation, when the 1959 Act imposed a "gain from operations" or "total income" based tax, mutuals nevertheless were allowed to deduct policyholder dividends against their entire gain from operations in excess of "taxable investment income." In effect, the 1959 Act allowed all mutual companies in all years of its operation to eliminate any underwriting gain component from their tax base through payment of policyholder dividends. */ As was the case between 1921 and 1957, then, the 1959 Act effectively taxed mutual companies only on their free investment income. Thus, at least for the years 1921 through 1981, the proposition that mutual life insurance companies have been taxed on contributions of equity capital through premiums received is without factual support.

This remains true under "stopgap". While stopgap limits mutual life insurers to deducting 77-1/2 percent of policyholder dividends, this is an alternative limitation. Mutuals are permitted to elect this alternative percentage deduction only if it provides them with a greater deduction for policyholder dividends than they would be allowed under the 1959 Act itself. Since the 1959 Act allows mutual companies to deduct dividends against all underwriting gain (and even

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*/ There have been a few instances in which a mutual life insurance company was actually taxed on premium income in excess of expenses and benefits paid, but these instances are few, far between, and trivial in amount.

against a portion of their investment income in excess of that required to fund policyholder reserves), under stopgap their tax base in fact is limited to their free investment income (albeit a smaller portion thereof). */

In sum, mutual life insurers have not been, and are not now, taxed on premiums received. Equity contributions by their policyholders are received tax free, identically with the treatment of shareholder contributions to the capital of a stock life insurer. The conceptual notion that parity exists because mutuals are taxed on contributions to capital remains, in the final analysis, just a conceptual notion.

Finally, one major mutual life insurance company has submitted for the record of the Subcommittee's hearings a lengthy paper on the ownership differential. **/ That paper advances a number of arguments, most of which relate primarily to the magnitude of return on equity to a mutual life insurer. As such we will have some observations on these arguments at the end of section III. At this point, however, we note that we do not, as the paper suggests, maintain that holders of participating policies issued by mutual life insurance companies have ownership interests possessing the same, formal characteristics as the interest of a shareholder. But if mutual policyholders are not in some real sense their companies' owners, surely no one else is. And, indeed, mutual policyholders do have rights (such as voting rights) similar to those of shareholders.

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*/ This should refute the suggestion, advanced by some mutual representatives, that under stopgap they are "taxed" on 22-1/2 percent of their underwriting income. They are subject to disallowance of 22-1/2 percent of their dividends paid only if they are using the alternative limitation, which is to say, only if they have already deducted dividends equal to underwriting gains plus a portion of their free investment income.

Presumably the approach currently advocated by mutual companies as a permanent solution would at least allow greater dividend deductibility than has prevailed under either the 1959 Act or stopgap; so that it, too, would continue to exempt mutuals from tax on premiums received.

**/ See "Statement of the Northwestern Mutual Life Insurance Company to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means," dated May 25, 1983 (the "NML Submission").

But, in the final analysis, the only really important point is that, as one aspect of their financial interaction with the life insurer, mutual policyholders play a role similar to that of shareholder. They supply ownership capital to the enterprise. As such their returns to that capital should be taxed consistently with the returns to ownership capital of other enterprises organized in corporate form. The importance of this notion is developed in the next section, which demonstrates why mutual life insurers provide their policyholders with an equity return.

II. The Need for and Evidence of an Equity Return

Writing life insurance requires capital. This is sometimes lost sight of, but were it otherwise, the shareholders of a stock life insurance company would be superfluous. The simple fact is that the aggregate costs of writing a new life insurance policy substantially exceed the premiums received in the year of issue. Recognizing, as one of the Subcommittee's invited witnesses emphasized, that "life insurance is sold rather than bought," */ one sizeable cost is the agent's commission. Another major cost is the first year policy reserve. To these must be added allocable indirect (or overhead) costs such as home office expense. The sum of these three items almost invariably exceeds the first year's premium. **/

In the case of a stock life insurance company, the shortfall experienced in writing new business is financed out of paid-in capital or retained earnings: in effect, the company's shareholders must invest in writing that new business. In the case of a mutual life insurance company the shortfall is made up from accumulated surplus -- that is, surplus built up from prior years' operations -- or from the elevated (or "redundant") premiums that mutual life insurance companies typically charge and currently receive from their policyholders. In other words, the new business of a mutual life insurer is financed either by pre-existing policyholders (through accumulated surplus) or by current policyholders (through redundant premiums), or by both. One way or another, new business written by a mutual life insurer is financed by its policyholders. */

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*/ Testimony of Joseph Belth, at 2.

**/ Obviously these statements must be qualified by the fact that statutory first year reserves may be reduced through conventional, "preliminary term" methods, intended to moderate the "strain" on a life insurer's surplus of heavy policy acquisition costs. The sum of commissions, overhead, and full net level premium reserves typically exceeds initial premiums by a substantial amount. Even using preliminary term reserves, however, first year expenses plus reserve additions usually exceed the first year's premiums.

Capital suppliers to a stock life insurance company obviously expect a return on their investment. It is difficult to believe that the capital suppliers to a mutual life insurance company do not insist on an appropriate return on their investment, in addition to (although perhaps not readily separable from) the value they receive from the company as customers.

The earnings accruing to a stock life insurance company and its shareholders are derived from (1) actual mortality more favorable than that anticipated by the company in designing its policies, (2) actual expenses lower than the assumed costs of writing and administering the policy, and (3) investment earnings in excess of those reflected in the policy reserve assumptions. The equity return, if any, to mutual company policyholders would be derived from the same three sources.

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*/ At least some mutual life insurers appear not to disagree with this assertion. For example, the NML Submission quotes and endorses the testimony of Dr. Norma Nielson to the effect that "each policy in a mutual company" makes "a permanent contribution to surplus. This finances the acquisition of a new policy just as previous policyholders finance the early years of one's own policy." Supplementary Comments to the NML Submission, at 2, citing Nielson testimony, at 8.

And, as we have already suggested, it is only (or at least principally) relevant for present purposes that in this financial sense the mutual policyholder may be said to be an "owner" of the company. The policyholder contributes ownership capital to, and shares in the return on, the company's equity.

In part, as mutual representatives maintain, the remittance to mutual policyholders through policyholder dividends of the benefits of favorable mortality and expense may properly be treated as a reduction in the price of their policies. As such, it would properly be deductible when paid by the enterprise and excludable from income by the policyholder. Nevertheless, favorable mortality and expense are one source of profit accruing to a stock life insurance company and its shareholders; and, when mutual policyholders systematically receive a greater share of the company's favorable mortality and cost experience than their stock policyholder counterparts, the incremental benefits properly may be regarded as a constituent of their equity return. Similarly, in some measure investment income credited to a mutual policyholder is comparable to investment income credited to the purchaser of a stock life insurance policy. But again, to some extent, the receipt by mutual policyholders of an increased share of the company's margin on its investment income is analogous to the contribution of investment gains to the earnings of a stock life insurance company. As such, it properly may be regarded as a constituent of a mutual policyholder's equity return.

It is quite difficult to isolate the precise extent to which mutual policyholders in fact are the recipients of an equity return. This is primarily because a single mechanism --

the distribution of policyholder dividends -- is used both to effectuate the "price reduction" to a mutual policyholder and to distribute any equity return. */ Since the constituent elements of policyholder dividends are not separately identified (much less quantified), it is naturally hard to determine the equity return component in mutual policy dividends.

The limited data available, however, at least seem consistent with the notion that mutual policyholders make equity contributions and receive equity returns. It appears that participating mutual policyholders, as reflected in consumer pricing surveys, **/ pay premiums that almost invariably exceed those paid by purchasers of guaranteed-cost nonparticipating policies for comparable coverage at comparable ages of issue. */ Similarly, such surveys suggest that, other things being equal, the amounts credited to the values of mutual participating policies are materially higher than the amounts credited to the values of guaranteed-cost nonparticipating insurance, again for comparable coverage at comparable ages of issue. **/ While comparisons of this sort must be handled with care, since their results may be attributable to other factors, the data are at least consistent with the proposition that, not only do purchasers of mutual participating policies make larger initial transfers of value to the enterprise, but also that their policy values reflect greater participation in gains from the companies' operations than is characteristic of guaranteed-cost nonparticipating insurance. In other words, though only suggestive, the data seem consistent with the presence of an "equity" or "ownership" return.

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*/ As Dr. Henry Aaron, one of the Subcommittee's invited witnesses, observed, a policyholder dividend:

> "...in principle, consists of a return of the excess premium, a return of interest earnings on the excess premium and any interest earned on the cash value of the insurance greater than was anticipated in setting the premium, and a rate of return on and possibly some repayment of the policyholder's equity share in the mutual insurance company."

H. Aaron, The Peculiar Problem of Taxing Life Insurance Companies 24 (Brookings Institution, 1983).

**/ Such as, for example, that carried out by Consumers Union ("CU") and published in 1980.

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*/ For example, the average annual premium for the best 10 non-participating policies ($25,000 face, age 25 at issue) in the CU survey was $250.20; that for the 10 best commercial participating policies (all of which were issued by mutual life insurers) was $308.10. The comparable numbers for issues at ages 35 and 45, respectively, were $378.70 vs. $435.20; and $585.40 vs. $693.90.

**/ The credit of earnings to policy values in the CU survey, expressed as yields on cash values at the 9th, 19th, and 29th policy years, tended on average to be about 65 percent higher on the 10 best commercial participating policies (all of which were issued by mutual life insurers) than for the 10 best guaranteed cost nonparticipating policies. This average was for all combinations of issue age and face amount surveyed.

III. Estimating the Magnitude of the Equity Return; Application to 1978

The 1959 Act limits the deductibility of policyholder dividends in a fashion designed to ensure taxation to a mutual company of some portion of its "free" investment income. No effort is made to tax the equity return to mutual policyholders as it is received. Consistently with the 1959 Act approach, most efforts of which we are aware to estimate the magnitude of the equity return to the mutual segment of the life insurance industry are framed in terms of the amount of dividends that implicitly would be disallowed under the method of estimation. In this section, putting aside the operation of the 1959 Act itself, we examine a procedure that might be used to estimate the size of the equity return. This procedure is simply a method of estimation. No effort is made to specify the level of non-deductibility implied for policyholder dividends.

In the published version of his paper, The Peculiar Problem of Taxing Life Insurance Companies (the "Aaron Report"), Dr. Henry Aaron proposed three possible ways of estimating the magnitude of the equity return. Under the first method, Dr. Aaron calculated the ratio of "gain from operations" to assets for stock life insurance companies as a whole, and applied the resulting ratio to assets of mutual life insurance companies to derive an estimated ownership return. */ Dr. Aaron then rejected this approach on the ground that the financial ratios entering into the computations for stock life insurance companies differed from those typical of mutual life insurance companies, thereby undermining the validity of the comparisons. **/ In his second method, Dr. Aaron suggested altering the financial ratios used in his first method, so that they were more typical of mutual life insurers. For reasons that are not clearly stated, however, Dr. Aaron appeared to have reservations about this method of computation, too.

Under a third method, Dr. Aaron first identified the "surplus" of mutual life insurance companies, as reported in their 1978 Annual Statements (using "statutory" accounting). He then imputed to that surplus a corporate rate of return of sufficient magnitude so that, after payment of corporate-level taxes, mutual companies would have sufficient after-tax earnings to distribute to their policyholders returns on surplus equal to the prevailing rate of interest on tax-exempt bonds.

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*/ In computing stock company "gain from operations" it is evident that Dr. Aaron used "gain from operations" as reported on Annual Statements in the form devised by the National Association of Insurance Commissioners ("NAIC"). These statements employ methods of accounting prescribed by the NAIC, usually designated "statutory" accounting.

**/ Dr. Aaron's actual calculations involved comparisons of earnings to "surplus" for stock life insurers, and then of surplus to assets for stock life insurers. The resulting ratio of earnings to assets was then applied to mutual assets to compute the ownership return. Dr. Aaron's specific concern was with the use of stock company ratios of surplus to assets in computing returns to mutual assets; this concern stemmed from the fact that, on average, the ratio of statutory surplus to assets of mutual life insurers tended to be only about 45 percent of the comparable ratio for stocks. Aaron Report, at 33-35.

We believe this "imputed return" method of approximating the equity return to mutual company policyholders (which we shall refer to as such, or as "Aaron Method Three") has merit. But we also believe that the methodology as proposed by Dr. Aaron could usefully be refined, in some respects in ways alluded to by Dr. Aaron himself.

Specifically, we believe that two modifications to this approach are in order. First, we believe that a substantial case can be made for using as the starting point a taxable rather than a tax-exempt rate. Second, it seems clear that mutual company "surplus," as defined by conservative statutory accounting standards, substantially understates the true "equity" of mutual life insurers.

A. Rate of Return

As applied by Dr. Aaron, the imputed return approach began by ascertaining the average rate on tax-exempt bonds. For the year of computation, 1978, this was found to be 5.9 percent. This rate was then converted (in jargon, "grossed up") to a rate of return which, if earned at the corporate level, would be sufficient to leave a net yield of 5.9 percent after imposition of corporate income taxes at a 48 percent rate. */ The "grossed-up" rate was 11.3 percent. **/

Any effort to estimate the equity return to a mutual life insurer should assume that such a return, when identified, would be taxed consistently with prevailing norms. The current norm for taxing corporate earnings calls both for corporate taxation and shareholder taxation on amounts distributed as dividends. It is arguable, then, that the estimation of returns to mutual equity should not necessarily assume, as Dr. Aaron did, that the returns will be received by policyholders free of tax. Dr. Aaron himself recognized "that the element of policyholder dividends deemed to be an equity return to the policyholder should have been included in the taxable income of policyholders under the accretion or consumption norm"; and that, if the equity return "were taxable at the personal level, the interest rate used" to impute ownership return "would be that on taxable assets." ***/

We therefore believe that the rate of return used in the imputed return computations should, at minimum, equal the interest rate available on taxable securities that are otherwise the counterpart of tax-exempt bonds. One possibility would be to use the prevailing rate on Treasury securities of intermediate duration. Another would be to use the rate on high-grade corporate bonds. Alternatively, one could derive a hypothetical "taxable security" rate from the rate on tax-exempt municipal securities. This would require adjusting the tax-exempt rate to a pre-tax equivalent yield sufficient so that, after payment of individual taxes at some assumed marginal rate, the after-tax yield would equal the rate of interest on tax-exempt securities. */ After making this adjustment the hypothetical taxable security rate would again be "grossed-up" for corporate taxes.

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*/ This is the corporate rate that prevailed during, but was reduced for years after, 1978.

**/ The "gross-up" is effectuated by dividing the tax-exempt rate by (1 - .48); 5.9/.52 = 11.3%.

***/ Aaron Report, at 36-37.

These approaches should be roughly consistent. **/ A case could be made for using the latter approach -- beginning with the tax-exempt rate and assuming individual taxation on average at some assumed marginal rate -- in the interest of consistency with the computations by Dr. Aaron for 1978. However, it seems more straight-forward to use a taxable rate with a single gross-up for corporate taxes. Thus, we have elected simply to use the rate on intermediate duration Treasury securities. The use of Treasury security (rather than corporate bond) rates is conservative. And, while the approach we have adopted produces a higher rate for 1978 than the use of grossed-up tax-exempt bond rates, for three of the five years surveyed in this and the following section, the method we have selected actually yields the lowest of the three options.

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*/ This is simply "grossing-up" the tax-exempt rate for individual, rather than corporate, taxes.

**/ That is, for some "break-even" marginal individual tax rate, the rate prevailing on taxable Treasury securities or high-grade corporate bonds, minus individual taxes at the break-even rate, will roughly equal the contemporaneously prevailing rate on tax-exempt securities of comparable grade and duration.

The average 1978 rate for 7-year Treasury securities, 8.36 percent, grossed-up for corporate taxes (at 48 percent), yields a pre-tax corporate return rate of 16.08 percent. */

B. Equity Base

Dr. Aaron applied the estimated rate of return to a base consisting of "mutual company surplus." This item was quantified by Dr. Aaron at $10.695 billion for 1978, derived from statutory surplus as reported on NAIC Annual Statements for 1978. **/

For purposes of estimating the equity-type return to mutual company policyholders, the mutual surplus or equity --

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*/ A 1978 rate derived from taxable corporate securities, using as a basis corporate bonds rated Aaa for which the average 1978 rate was 8.73 percent, would be 16.79 percent. If, instead, one were to gross-up the tax-exempt rate of 5.9 percent, the required adjustment would be for both individual taxes (at, say, 25 percent) and corporate taxes (at 48 percent), by dividing 5.9 by (1 - .25) (1 - .48), or .39. Doing so yields an imputed pre-tax corporate return rate of 15.13 percent. The return so computed, if taxed at 48 percent, with the amount remaining taxed again at 25 percent, would leave a return after all taxes of 5.9 percent.

All interest rate data were derived from periodic compilations of "Financial and Basic Statistics" regularly published in the Federal Reserve Bulletin.

**/ A company's statutory surplus is reported on page 3, line 29D, of the Annual Statement.

properly defined -- would appear to be the appropriate base on which the return is to be computed. It would also seem appropriate to state this surplus or equity figure for any year as the mean of the values at the beginning and end of the year. Care must be taken, however, to define "equity" with reference to all resources of a company that are realistically providing an equity-type return to the policyholders in their capacity as owners. Thus, all resources other than those committed to the fulfillment of obligations to policyholders in their capacity as customers should be included in this base; and equity also should include investments of a company which produce an economic return, whether or not recognized for State regulatory purposes and, in some instances, even though the investment may be accounted for as an expense in regulatory accounting.

In light of this, the equation of mutual company "equity" to "statutory surplus" would materially understate true equity. The real equity of a mutual company extends well beyond the Annual Statement's "surplus". A number of additional items may be considered, of which we will dwell on only four, in arriving at a realistic picture of mutual company "equity."

Each of these items is described below. For purposes of illustration, we also have quantified the mean value of each item for 1978, using a sample consisting of 10 of the largest mutual life companies domiciled in the U.S., generally reckoned to account for about 70 percent of the mutual segment of the industry. */ Thus, when all adjustments have been made for the sample, an estimate for the entire mutual segment will be derived by dividing the figures by .7.

Mandatory Securities Valuation Reserve. The "Mandatory Securities Valuation Reserve" (or "MSVR") appears as a liability on the Annual Statement, and therefore reduces statutory surplus. This treatment is required for statutory accounting "even though," in the words of a leading text, "its nature is basically that of a contingency fund or earmarked surplus." **/ More specifically, the MSVR is a bookkeeping item accumulated over a period of years "to protect against adverse fluctuations in the values of securities (bonds and stocks) and against losses on their sale," and companies may (within limits) add to the reserve more than the required annual increment. ***/ Thus, while the MSVR plays an important role in assuring the overall fiscal integrity of a life insurance company, it is not a reserve held in fulfillment of policy obligations. It therefore should be taken into account in determining true equity.

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*/ In order of size (by assets, as of December 31, 1978), the companies are Prudential, Metropolitan, Equitable, New York Life, John Hancock, Northwestern Mutual, Massachusetts Mutual, Mutual of New York, Bankers Life (Iowa), and Connecticut Mutual. The statutory surplus of these 10 companies as of the end of 1978 was $7.389 billion, or 69.1 percent of the statutory surplus for the entire mutual segment of the industry, as used in Dr. Aaron's computations, of $10.695 billion. Similarly, assets of these 10 companies as of the end of 1978 amounted to some $172.771 billion, or about 72.1 percent of the $239.699 billion in assets for the entire segment, as used by Dr. Aaron.

**/ S. Huebner and K. Black, Life Insurance 631 (10th ed. 1982) ("Huebner and Black").

***/ Ibid.

For 1978, the mean value of the aggregate MSVR for the 10 mutual life companies in our sample was approximately $1.775 billion. */ This figure amounts to nearly 25 percent of the 1978 mean statutory surplus reported by those 10 companies of about $7.055 billion.

Policyholder Dividends Not Yet Payable. Though again shown as a liability that reduces surplus, the provision for policyholder dividends to be paid in the following year **/ clearly represents a pool of assets remaining in a company's hands as of the end of a year and that have produced earnings during the year that inure to the benefit of the company and its policyholder-owners. ***/ As such, this item, until liquidated by payment at a later date, may properly be characterized as part of the company's equity. For 1978, the mean value of this item amounted to $3.883 billion for the 10-company sample. ****/

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*/ Derived from page 3, line 25.1 of the Annual Statements of these 10 firms (the "Annual Statements").

**/ Annual Statements, p. 3, lines 7.1. and 7.2

***/ Annual additions to this reserve, which represents dividends formally declared as of December 31 but not yet paid, allow the company to deduct in computing taxable income of the current year dividends not actually paid until the following year.

****/ Although dividends declared are actually liquidated through payments the following year, the reserve is then augmented through dividends declared as of the end of the following year. Typically,

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Non-admitted Assets. In contrast to the foregoing two items, which are classified as liabilities for accounting purposes even though they are correctly viewed as a constituent of surplus, two other items may be considered as part of mutual company equity even though they technically do not appear on the statutory balance sheet. The first of these is non-admitted assets, that is, investments made by a company that are not recognized under State regulatory accounting precepts. Such assets are disregarded, for purposes of testing the solvency of the company, in the interest of conservative reporting of its financial position, */ even though they are capable of producing (and do produce) a return to the company's owners. For 1978, the aggregate mean value of certain non-admitted assets of the 10 companies in our sample may be conservatively stated as $.402 billion. **/

Unamortized Acquisition Expense ("UAE"). The other investment that produces revenue for the company and therefore should be included in the company's equity, but which does not

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the reserve shows a year-to-year increase. Use of the entire reserve remains conservative, since no return is imputed to dividends actually distributed during a year, which, until distribution, presumably were invested and contributing to earnings.

*/ Huebner and Black, supra, at p. 624.

**/ Annual Statements, p. 14, Exhibit 14. It should be noted that Exhibit 14 includes only that portion of the non-admitted assets which are in the nature of working capital.

appear as a balance sheet asset, is the cost of "placing business on the books" that has not been amortized.

As we have already noted, when a company issues a policy, it incurs a variety of expenses, _e.g._, sales commissions, medical examination fees, investigation charges, and home office administrative costs. For State regulatory accounting purposes, these outlays are treated simply as expenses in the year incurred, although admittedly they are made for the acquisition of policies that are expected to produce a stream of earnings for a number of years.

> "Commissions and other costs of acquiring new business are charged to operations as they are incurred, rather than being deferred and charged to operations as the related income is received. As a result, there is usually a substantial drain on reported surplus for each new policy sold (particularly if reserves are set up on the net level premium basis). Consequently, an increase in the amount of new insurance sold on an apparently profitable basis may produce the anomalous result of a decrease in the reported net gain from operations, and a decrease in the new insurance sold may result in an increase in the net gain from operations." */

This treatment is appropriate for displaying annual operating gains or losses. The fact is, however, that these outlays are made with the expectation that they will yield returns over a period of years. Consequently, they are properly viewed as a

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*/ Heubner and Black, _supra_, at p. 620.

constituent of the company's "equity," at least to the extent not yet amortized. */

Because the UAE does not appear as such in the Annual Statement, any attempt to value it will require that it be derived indirectly from other Annual Statement data, and this effort will, in turn, necessitate some estimation. A methodology for estimating UAE figures, based on specified assumptions regarding interest rates, policy lapse rates, and amortization periods and employing Annual Statement data for premiums on new direct business, is included in Appendix A. This methodology appropriately adjusts for the fact that only the excess of the UAE over the reserve expense allowance (if any) should be added to the statutory surplus to determine overall equity: the amount of the reserve reduction made available by the use of a preliminary term (as contrasted with a net level premium) reserve method already provides for the reflection of a portion of the UAE figure in statutory surplus. Our estimate of the mean value of the

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*/ Existing tax treatment calls for policy acquisition costs to be deducted currently. A question has been raised about the appriateness of this treatment. We believe that, for a variety of reasons, allowance of a current deduction for these costs remains sound. Nevertheless, the business placed on a company's books as the result of having incurred these costs contributes to the company's earnings over time.

We have reconciled these considerations by estimating the magnitude of the UAE as a constituent of equity; but, then, by allowing as a current deduction in estimating mutual taxable income the expenses incurred in placing new business on the books, at least where the new business represents "growth." See pp. 27-28, infra.

UAE in 1978 produced using the methodology set out in Appendix A is approximately $7.64 billion for the 10-company sample. Obviously, this is a material item, about equal to the statutory surplus of those companies. */

Summary. The foregoing adjustments produce a revised "mutual company surplus" -- or true "equity" -- for the 10-company sample having a mean value in 1978 of $20.705 billion, derived as follows:

10-Company Sample -- 1978

Statutory surplus	$7.055 billion
MSVR	1.775 billion
Provision for policyholder dividends	3.833 billion
Non-admitted assets	.402 billion
UAE	7.64 billion
Equity (est.)	$20.705 billion

We believe this to be a more realistic estimate of the true "equity" of the 10 companies in our sample for 1978. Assuming these companies to constitute 70 percent of the mutual segment of the industry, the implied equity of the segment is $29.579 billion. **/

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*/ This estimate may be inherently conservative. For example, in computing the UAE for the 10-company sample, the estimate was made only for ordinary life insurance; UAE on other lines of business (such as pension, deferred annuity and industrial life insurance) was assumed to be zero. See Appendix A.

**/ That is, $20.705 divided by .7 = $29.579 billion.

C. Equity Return and Tax Computations

If the rate used by Dr. Aaron to impute a return to equity is modified, as we have proposed, to take account of taxation that would be imposed on dividends distributed to shareholders of an investor-owned enterprise, the appropriate rate would be approximately 16.08 percent. That rate, when applied to the estimated mutual equity, yields an estimated pre-tax return to that equity in 1978 of $4.756 billion.

Before proceeding to a tentative computation of taxable income and tax, at least one other item must be accounted for in this procedure. It stems from the fact that, while unamortized acquisition expense properly may be regarded as part of a life insurer's "equity," actual acquisition costs are a currently deductible expense in computing not only statutory gain from operations but also taxable income. To the extent that a life insurer incurs acquisition costs in writing new business during any year, those expenses are allowable as a deduction in computing the insurer's income for Federal tax purposes. Some portion of these outlays, of course, are simply a surrogate for the aggregate of the deduction the company would be allowed for amortization if, instead of being expensed, acquisition costs were to be capitalized and amortized. */ Conse-

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*/ That is, for a company that has been in business for a number of years, and which is not growing, a system of capitalizing and amortizing each year's aggregate acquisition costs would, sooner or later, give rise to an aggregate annual amortization deduction equal to the deduction that would be available each year if, instead, the company simply expensed all acquisition costs.

quently, to the extent that business newly placed on the books in a particular year simply replaces business that lapsed during that year, no special provision need be made to account for growth. On the other hand, to the extent that newly written business exceeds the amount of business that lapsed during the year, the excess may properly be regarded as an incremental investment in growth by the company and, under existing law, the costs of writing that business are allowable as a deductible expense in computing taxable income.

Consistently with this treatment, we have made an estimate, the methodology for which is also included in Appendix A, of the deduction that would appear to be allowable on account of reinvestment of 1978 earnings in the mutual companies' growth. This was computed by estimating that portion of the new annual premiums for 1978 that exceeded premiums (1) that would have been received in respect of business on the company's books as of the beginning of 1978, but which (2) in fact were not received because of estimated policy lapses during the year. This estimate of the incremental new annual premium, approximately $501 million, was multiplied by an estimated ratio of acquisition costs to first year premiums of 1.5 to arrive at an estimated deduction for investment in growth of $752 million for the 10-company sample. Expanded to account for the entire mutual segment, this deduction amounts to some $1.074 billion for 1978. */

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*/ The numbers in the text are for the entire mutual segment. In the charts appearing in Appendix B, the actual computation of

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Corporate Tax. Subtracting the growth deduction from the estimated return on modified equity of $4.756 billion in 1978 yields taxable income for the mutual segment of $3.682 billion. The tax on this (at 48 percent) would amount to $1.767 billion. These numbers are to be contrasted with an estimated equity return for the mutual segment of $1.210 billion, the tax on which would be $580 million, arrived at by Dr. Aaron using a tax-exempt rate and statutory surplus.

Individual Tax. The tax liability arrived at by our refinement of the imputed return approach does not actually include any estimate of individual tax liabilities imposed on after-tax corporate earnings distributed to policyholders. */ If, as with dividends declared by a stock life insurance company, distributions of equity returns to mutual policyholders were ac-

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the equity return and allowance of the "growth" deduction are carried out for the 10-company sample. The resulting figure is then expanded to an estimate for the mutual segment. The only year for which a difference in approach appears is 1978. The estimate in the charts of return on modified equity for the 10-company sample of $3.329 billion is 70 percent of the $4.756 billion estimate for the segment appearing in the text; and the growth deduction of $752 million for the 10-company sample is 70 percent of the allowance of $1.074 billion in the text.

*/ That is, "grossing up" a taxable bond rate for corporate-level taxes results in imputing a return sufficient so that, after payment of corporate taxes, and taxing after-tax corporate income again at individual rates, the results will (for some assumed marginal individual rate) be equivalent to the individual yield, after individual taxes, on the taxable securities involved. Simply taxing the return imputed through this rate at the corporate level does not, however, actually replicate an individual-level tax.

tually includible in their income, additional tax liabilities would arise. As we have developed this procedure, aggregate pre-tax corporate earnings of $3.682 billion, less tax of $1.767 billion, leaves aggregate after-tax corporate earnings of $1.915 billion. This amount, if distributed to policyholders and taxed on average at a marginal rate of 25 percent, would yield additional individual tax liabilities of $479 million.

This estimate assumes full distribution of the entire equity return after corporate taxes. That assumption probably is little more realistic for a mutual life insurer than for any other corporate enterprise. One might, on the contrary, assume that policyholder dividends operate to distribute the equity return only to the extent such dividends reduce a company's gain from operations to a figure below estimated earnings. This assumption seems no more realistic than the first. As a matter of convention, therefore, we can simply assume, in making estimates for 1978 (and the other years sampled in the next section), that after-tax corporate earnings were distributed in the same proportion as the ratio of policyholder dividends to gain from operations. Since the ratio of dividends to pre-dividend gain from operations for our 10-company sample was 65.66 percent for 1978, we have estimated that the same fraction of the $1.915 billion of after-tax corporate earnings, or $1.257 billion, was distributed during 1978. The tax on this amount, at a marginal rate of 25 percent, would have amounted to $314 million.

In sum, the aggregate individual and corporate liabilities that would be imposed on the imputed equity return to mutual policyholders in 1978 under this method of estimation amount to $2.082 billion. */ This would consist of corporate tax liability on the 1978 ownership return of $1.767 billion, and aggregate individual tax liabilities on the after corporate tax return, to the extent deemed distributed to owners, of $314 million.

The foregoing computations are summarized in Appendix B.

D. Nature and Reasonableness of the Estimate

It is appropriate to underscore at this point that the procedure we have outlined simply estimates pre-tax net income at the corporate level, corporate tax, distributions of earnings

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*/ It is, at least in theory, possible to impose the individual level tax, assuming some average individual marginal rate, through a so-called "proxy tax" levied at the corporate level. For an assumed marginal individual rate of 25 percent, the addition to the corporate tax base, assuming full distribution and individual taxation of earnings, would equal .2708 times the corporate tax base. If, however, it is assumed that less than 100 percent of earnings are distributed this factor must be reduced to a percentage corresponding with the percentage of earnings distributed. Thus, for 1978, the actual "proxy adjustment" would equal .2708 x .6566, or .1778. If the 1978 corporate tax base of $3.682 billion were multiplied by 1.1778, the "proxy adjusted" corporate tax base would be $4.337 billion. The tax on this base at 48 percent would be equal to $2.082 billion. This equals the sum of the corporate and individual tax liabilities derived in the text.

Assuming full distribution of earnings, the adjusting factor is equal to $1 + r_I(1/r_C - 1)$, where r_I is the individual tax rate and r_C is the corporate rate. Where less than all earnings are distributed, the second term in the expression must be multiplied by the percentage of earnings distributed.

and individual tax. It provides an estimate of equity return with what seems to us appropriate taxation at each stage. It is not properly understandable in terms of some specified "ownership differential," at least in the sense that that term has come to be used by certain mutual companies as denoting some arbitrary percentage (zero, as we understand them) of policyholder dividends that properly should be disallowed. On the other hand, to the extent that actual distributions of dividends in any year operate to reduce a company's gain from operations below the pre-tax "equity return," our view is that the difference properly should be non-deductible. The amount disallowed may reasonably be expected to vary from year to year. Despite this, we have attempted to estimate an equity return, not an "ownership differential."

In a back-handed way, many of the mutual representatives have endorsed the sort of estimating procedure developed by Dr. Aaron and refined as we have suggested above. For example, the NML Submission seemed to interpret Dr. Aaron as arguing that the equity return estimated through his procedure should be translated directly into a dollar amount of mutual dividends disallowed as a deduction. Such a procedure would potentially lead to double taxation of earnings at the corporate level since, even after deducting all dividends, a mutual might have some remaining taxable income. While passages from Dr. Aaron's paper are susceptible to this interpretation, we do not so understand him. To us, it seems clear that Dr. Aaron's view was that the equity return as identified through imputation ought properly to be the tax base of the mutual life insurer. */

As so understood, we read much of what is said in the NML submission as consistent with Aaron Method Three. Indeed, we understand them to advocate steps "to make sure that taxable income is not reduced to less than the earnings on equity of the enterprise." **/ The procedure we have described is simply a refinement of the effort to estimate those earnings.

In the same vein, the Zinn-Groom Paper suggests that an appropriate measure of the "company level differential is the portion of mutual company return on equity that escapes company level taxation as a result of being distributed to policyholders." And they proceed to estimate returns to mutual equity by multiplying a hypothesized surplus figure -- but one which is consistent with typical mutual surplus to asset ratios -- by a company's current, portfolio earnings rate. */

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*/ That this is his interpretation is confirmed by his view that one way of taxing mutuals would be to allow a full deduction for policyholder dividends, but then to impute the equity return back to the company. Aaron Report, at 36.

**/ Supplementary Comments to NML Submission, at 8. Elsewhere the NML Submission points out that:

> "If Professor Aaron had followed the logic of his own analysis and, after having established procedures for measuring 'equity return' for a mutual company, taken the next step, his contribution would have been even more valuable. He failed to identify the equity earnings routinely included in the income base of a mutual company and thus suggests that equity earnings be added to reported income." (Supplementary Comments to NML Submission, at 6, n.3 (emphasis added).)

As we already have said, we believe that Dr. Aaron did not actually propose taxing mutual life insurance companies on reported income plus disallowed dividends, but only on a tax base consisting at least of equity return.

These submissions, then, appear consistent with the general approach of Aaron Method Three. But we are under no illusion that mutual companies would agree with Dr. Aaron's actual estimates, much less with ours. On the question of measuring true equity, both the surplus and MSVR figures are drawn from actual Annual Statement data, and we do not believe the mutuals could reasonably quarrel with inclusion of the latter item in surplus. **/ As for the provision for dividends payable in the following year, this reflects the presence of assets that clearly have contributed to mutual company earnings for the year for estimation. The only "soft" number is our estimate of the UAE. But, at least, in concept, it is difficult to dispute the importance of including this item in equity. And, as Appendix A indicates, we have attempted to be conservative in our estimate of the UAE. We believe, in sum, that our procedure for estimating mutual equity is sound.

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*/ Zinn-Groom Paper, at 9-10.

**/ Indeed, even statutory accounting, which treats MSVR as a liability in computing surplus, nevertheless treats changes in MSVR as changes in surplus in computing statutory gain from operations.

We also have no doubt that the mutuals would take issue with the rates we have used to impute a return to mutual surplus. And, even putting aside the fact that the rate for 1978 (and, indeed, for all other years sampled in section IV), is well below NML's estimate for the mutual segment of a 29.8 percent return on equity, */ a word of explanation is in order.

The Zinn-Groom Paper suggested imputing an equity return using the portfolio earnings rate of approximately 8 percent. And one might indeed question the propriety of imputing earnings at a 15 percent rate to equity of a company whose actual portfolio yield is only eight. But the simple answer to the Zinn-Groom Paper is that it entirely overlooks the fact that the surplus of a life insurance company is capital invested in a business. It is not simply the investment of excess cash as part of the company's portfolio, as the Zinn-Groom paper suggests. The surplus makes possible -- and is entitled to share in -- the gains from the operation of the enterprise as a whole. Thus, the Zinn-Groom Paper entirely ignores the contribution to earnings on equity from such items as favorable mortality and expense. And it overlooks the contribution to equity earnings from margins on the investment by the company of assets held to meet its liabilities.

The importance of this point can be readily illustrated. If, for 1978, the mutual segment were assumed to have derived

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*/ NML Submission, at 6.

only a 1 percent investment margin on liabilities, that margin, together with investment earnings on "hard" surplus */ at the actual portfolio rate, would amount to $3.39 billion. **/

Viewed in this context, the use of rates of the order of magnitude that we have developed is hardly excessive. Tied as they are to actual rates on high-grade corporate or governmental securities, they are nowhere close to imputing returns to mutual equity at the rates of return for which investor-owned enterprises of all sorts routinely price their products (and which they frequently achieve). They are not "embarrassingly wild flights of fancy" which attempt to "key" the "taxation of" one group of taxpayers to the "profitability . . . of a different and unrelated group of taxpayers". ***/ And they do not suggest that one group of taxpayers should be taxed "on the income they would have earned if they had done something else," rather than "on the income they have earned from doing what they actually" did. */ We simply have endeavored to estimate mutual companies' earnings from what they actually did.

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*/ That is, surplus as we have computed it minus UAE and nonadmitted assets.

**/ The estimated mean value of mutual company cash plus invested assets for 1978 was approximately $227.5 billion. Subtracting from that figure our estimate of "hard" equity of approximately $18.1 billion leaves assets matched by liabilities of approximately $209.41 billion. A one percent margin on these assets on average would create "excess" portfolio earnings of $2.094 billion. When added to earnings on hard surplus of $1.296 billion at the portfolio rate of 7.16 percent (derived from data for our 10-company sample), the result is $3.39 billion.

***/ NML Submission, at 4.

The realism of the orders of magnitude derived from this procedure may also be checked by comparing the estimated results with actual gain from operations (before dividends) as reported by the mutuals on their NAIC Annual Statements. Pre-dividend gain from operations during 1978 for the 10-company sample was $7.048 billion. **/ Our 1978 estimate of pre-tax income for these 10 companies of $2.577 billion amounts to only 36.6 percent of pre-dividend gain. Thus, for 1978 our estimating procedure leads to the conclusion that about one-third of pre-dividend gain constituted ownership return.

One final, but quite significant, note is in order. The bulk of the discussion in this section has attempted to approximate the true "surplus" or "equity" figure for a mutual life insurer; and we have approached this by adding to statutory surplus certain other items that are rightly associated with that amount. Existing tax law, however, already contains a device for determining a life insurance company surplus figure independently of statutory surplus. This device is found in section 819 of the Code, which partly bases the tax treatment of the U.S. operations of foreign life insurers on the ratio of surplus to assets of U.S. life insurers. This ratio is announced by the Service each year based on data annually reported by U.S. life insurers on Schedule K of Form 1120L.

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*/ Zinn-Groom Paper, at 4.

**/ This ignores a positive change of $306 million in the provision for policyholder dividends payable during the following year, which justifiably could be included in computing gain from operations.

The Schedule K data shows, for all U.S. life insurance business, the total assets (properly valued) and the total actual liabilities of the companies. The difference between these two totals is, of course, the surplus, and this surplus figure, divided by the total asset figure, yields the section 819 ratio. Hence, this ratio represents the average proportion of surplus to assets of all domestic companies (on a mean basis), at least from the standpoint of an existing provision of the tax law. */

For 1978, the section 819 ratio as proclaimed by the Service was 13.9 percent. **/ If total mutual life company assets for 1978 (on a mean basis), $220 billion, ***/ were multiplied by this ratio, this would yield a surplus or equity figure of $30.58 billion. If this figure were then multiplied by our modified rate of return, the mutual equity return for 1978 would be $4.92 billion, a figure considerably higher than the one produced by the methodology we previously outlined. (The resulting tax, at the corporate level alone, would be $2.36 billion for 1978, which is $0.593 billion greater than the corporate-level tax resulting from our basic methodology.) Even if the proportion of surplus to assets is lower for mutual than for stock life insurers, */ this strongly indicates to us that our previously computed figures (and underlying methodology) are conservative.

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*/ The UAE is not taken into account.

**/ Notice 80-4 (March 26, 1980), 1980-1 C.B. 577. There is, of course, about a one-year delay between the filing of returns and the promulgation of a ratio based on the return data.

***/ This figure is for mean "tax assets," based on data compiled by the American Council of Life Insurance from tax returns for 1978. If statutory assets were used, the mean figure for 1978 would be $229.6 billion.

IV. Imputed Return Method Applied to Selected Other Years

The procedure for estimating the equity return as developed in the preceding section might also be employed to derive equity return figures, and tax liabilities, for years prior to 1978 (and since the effective date of the 1959 Act). We have made the calculations to derive these figures and liabilities for a sample of years -- 1975, 1970, 1965 and 1960 -- that we believe are not unrepresentative of life insurance industry financial experience since the 1959 Act took effect. These results, the underlying details of which also appear in Appendix B, are as follows:

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*/ While mutuals are generally believed to hold lower ratios of surplus to assets than stocks (*see*, *e.g.*, Aaron Report, at 34), such ratios are probably comparable for large insurance companies, regardless of whether they are stock or mutual. (That is to say, large stock companies, like large mutuals, tend to hold lower surplus in relation to their assets.) If the section 819 ratio is an average for the industry weighted by company size, then the actual percentage might correspond relatively closely with numbers reported on Schedule K by the mutuals.

1975. Using a modified equity base of $17.091 billion for our 10-company sample and a modified grossed-up rate of 15.19 percent, the tentative equity return is $2.596 billion. This figure, reduced by a deduction for reinvestment in growth, yields an estimated taxable base of $2.074 billion. This implies, for the entire mutual segment of the industry --

a corporate tax of $1.422 billion, and

a shareholder proxy tax of $0.290 billion, for a total of $1.712 billion.

1970. Using a 10-company equity base of $15.484 billion and a modified grossed-up rate of 13.42 percent, the tentative equity return is $2.078 billion. This figure, reduced by the deduction for reinvestment in growth, yields an estimated taxable base of $1.760 billion. This implies for the mutual segment --

a corporate tax of $1.207 billion, and

a shareholder proxy tax of $0.251 billion, for a total of $1.458 billion.

1965. Using a 10-company equity base of $13.239 billion and a modified grossed-up rate of 8.10 percent, the tentative equity return is $1.072 billion. This figure, reduced by the deduction for reinvestment in growth, yields an estimated taxable base of $0.817 billion. This implies, for the mutual segment --

a corporate tax of $0.561 billion, and

a shareholder proxy
tax of $0.110 billion, for a total of
$0.671 billion

1960. Using a 10-company equity base of $9.568 billion and a modified grossed-up rate of 8.33 percent, the tentative equity return is $0.797 billion. This figure, reduced by the deduction for reinvestment in growth, yields an estimated taxable base of $0.569 billion. This implies for the mutual segment --

a corporate tax of $0.423 billion, and

a shareholder proxy
tax of $0.069 billion, for a total of
$0.492 billion

APPENDIX A

DESCRIPTION OF PROPOSED METHOD FOR ESTIMATING UNAMORTIZED ACQUISITION EXPENSE AND GROWTH DEDUCTION

PROPOSED METHODOLOGY FOR ESTIMATING UAE

For life insurance companies, the Unamortized Acquisition Expense ("UAE") is most significant for ordinary life insurance, and this discussion will focus on that line of business.

The following methodology was developed to arrive at a reasonable estimate of the UAE for a block of ordinary life insurance. The methodology then was applied to estimate the UAE for the 10-company mutual sample described in the text. It does not provide a precise measurement. Even with specific data for each company in the sample, which is not available from Annual Statements, developing a precise figure would be difficult. Nevertheless, we believe our estimate is reasonable; and, if anything, that it errs on the side of conservatism.

(1) Data and Assumptions

The procedure made use of the following data and assumptions:

Premium Data. We began with first year annual premium data. For years 1974-78, we used Annual Statements, Exhibit 1, Part 1, Line 9A. For earlier years, we used corresponding data obtained from Volume I of the annual New York Insurance Reports, which reproduce statutory Annual Statement data for companies licensed in New York. (These reports were discontinued in 1971.) For these earlier years, we obtained actual first year premium data for our 10-company sample at five year intervals for the period 1935-1970. The data for all other years were estimated using a graduation process.

Magnitude of Acquisition Costs. We assumed that acquisition expenses (first year commissions, marketing expenses, underwriting costs, etc.) amounted to 150 percent of first year premium. This estimate was based on:

(a) experience with expense-to-premium ratios for stock companies,

(b) judgments about expense-to-premium ratios for mutual companies (which, for some companies, we believe to be on the order of 200 percent or more), and

(c) acccountants' estimates that acquisition expenses are as high as 80 percent of total expenses associated with ordinary life insurance. (Using 1978 data, this 80 percent estimate translates into 196 percent of first year premiums.)

On the basis of the foregoing we believe our 150 percent assumption to be conservative.

Rate of Amortization. We assumed that initial acquisition expenses are properly amortized in proportion to the receipt of premium income. In other words, we have assumed that a level percentage of each year's premium is available to absorb a portion of the initial acquisition costs. This assumption is reasonable in view of the level premium nature of ordinary life insurance.

The operation of this aspect of our methodology may be illustrated through a simple example. The example assumes that, for a block of 3-year term policies, expected annual premiums are $1,000, 600, and 400, respectively; and, that total acquisition costs are $500. Ignoring the effect of interest, the percentage of premium revenue treated as applied to recover acquisition costs in any year corresponds to the acquisition expense ($500) as a percentage of total premiums ($2000), or 25 percent in this instance. Thus, we would amortize $250 (25 percent of $1000) of the $500 in year 1, $150 (25 percent of $600) in year 2, and 100 (25 percent of $400) in year 3.

In reality, we must also take interest into account in the amortization process. Since the $500 of acquisition cost is paid out in year 1, it is necessary to amortize over the three year period a total amount having a present value equal to $500. To ascertain the percentage of revenue to be amortized each year, taking interest into account, we can divide the acquisition expenses (still $500) by the present (rather than the undiscounted) value of the expected premiums at issue. At 10 percent, this present value is $1,876, so that the acquisition percentage is 26.65 percent ($500 divided by $1876) instead of 25 percent.

The computation of the amounts amortized, and the development of the UAE, are illustrated below.

Year	(1) Premium Beginning Of Year	(2) UAE, Beginning of Year, Before Amortization	(3) Amortization (1)x.26652	(4) UAE, Beginning of Year, After Amortization (2)-(3)	(5) UAE, End of Year (4)x1.10
1	$ 1,000	500	$ 266.52	$ 233.48	256.83
2	600	256.83	159.91	96.92	106.61
3	400	106.61	106.61	0	0

(2) Computing UAE For a Series of Years

For our estimate of the current total UAE, we must look at a series of prior issue years; compute the initial acquisition expenses for each such year; determine the UAE remaining as of the current date for that issue year; and then compute the sum of these items for the entire series of issue years. For any constituent issue year, the process for determining the UAE asset is the same as for the simple example above.

This process also requires several assumptions:

Interest. We have assumed 8 percent interest. One could argue for the use of a higher rate on the basis that an investor would demand a higher rate of return on his investment; or for a lower rate, on the basis that the rate should reflect current after-tax interest rates. In any event, we found that the UAE estimate is not terribly sensitive to the interest assumption. */

Amortization Period. We have assumed that acquisition expenses are entirely amortized during the first 15 policy years. Using a longer period would increase the magnitude of our estimate of the UAE, perhaps by a substantial amount. **/ Indeed, one may reasonably argue that acquisition expenses should be amortized over the life of a policy, or at least over the period during which premiums are received. We elected to use 15 years largely to simplify our computations, ***/ and to anticipate the suggestion that a policy lifetime amortization period would be too long (and our estimate of the UAE too high). In the final analysis, the 15-year assumption builds a substantial measure of conservatism into the estimates.

Effect of Policy Lapses. Although annual premiums for each policy are level, aggregate annual premiums for a block of policies issued during a given year are not, due primarily to policy lapses. Thus, an estimate of the pattern of decline in annual premiums for the block of business for a given issue year is required to establish the amortization schedule. To estimate this pattern, we computed a persistency factor based on LIMRA 1977-78 lapse rates for participating ordinary insurance. */

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*/ For example, using 6 percent in place of 8 percent reduced the UAE estimate by less than 1 percent.

**/ The use of 20 years in lieu of 15 would increase our estimates by about 17 percent.

***/ As the result of this assumption each estimate of the UAE requires an examination only of the 15 years preceding the year for which an estimation is being made.

On the basis of these assumptions, we computed the UAE, per $1 of annual premium still in force n years after issue, where n varies from 1 to 15. The development of these factors is shown in Exhibit 1.

Computation. To compute the UAE, we used the same persistency factors just described to estimate how much of each past issue year's annual premium was still in force as of the current date. Multiplying this estimate by the UAE factors yields the UAE asset for that issue year. Summing these results for all 15 issue years provides the total UAE estimate.

A sample computation is presented in Exhibit 2. (This computation is for 1978, but ignores the effect of CRVM, discussed below. It therefore is greater than our final UAE estimate for 1978).

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*/ The Long-Term Lapse Study: 1977-1978 Experience; Life Insurance Marketing and Research Association, Inc. ("LIMRA"); Hartford; Table 6. Lapse rates, by policy year: 15%, 10%, 7.5%, 6.5%, 5.75%, 5.0%, 4.5%, 4.25%, 4.0%, 3.75%, 3.5%, 3.25%, 3.0%, 2.75%, 2.5% thereafter.

(3) CRVM Adjustment

The first year premium is used by the insurance company to:

(1) pay first year mortality costs,

(2) pay for "level" annual expenses, other than acquisition expenses,

(3) fund the increase in benefit reserve, and

(4) amortize a (small) portion of the initial acquisition expenses.

In recent years, companies have generally computed their statutory benefit reserves using the Commissioners' Reserve Valuation Method ("CRVM") which implicitly recognizes the existence of heavy first year acquisition expenses. Under this method the statutory reserve at the end of the first year is generally zero, permitting the company to cover a much greater portion of its acquisition costs with the first year premium. As a result, the acquisition expenses not apparently recovered out of first year premium are greatly reduced, perhaps by as much as 50-80 percent of first year premium. In estimating the ratio of acquisition costs to first year premiums, and, hence, the UAE to be added to statutory surplus to estimate equity, it is appropriate to make a corresponding adjustment. (Viewed slightly differently, the "strain" on surplus has already been eased by the reduction in first year reserve.) On the other hand, we are reluctant to reduce our acquisition cost estimate of 150 percent of first year premiums by the full 50-80 percent, for the following reasons:

- We believe the 150 percent estimate to be low to begin with; the actual figure well may be closer to 175 and conceivably as high as 200 percent.
- The CRVM reserves in fact understate the company's true liabilities at the end of the year, and hence overstate the amount of first year premium available to cover acquisition expenses.

As a compromise, we have assumed that the acquisition expenses to be amortized equal 100 percent of first year premium, in place of the 150 percent used elsewhere, where CRVM reserves are used. Furthermore, we have assumed mutuals used CRVM reserves in full only in years 1976 and thereafter. This is reasonable in light of the Annual Statements, which disclose that seven of the ten companies in the sample did not begin to shift to CRVM until 1976 or later.

(4) Results

The final results are presented below. Results are displayed for successive year-ends to permit computation of an estimate of the mean UAE for each computation year.

Year	UAE End of Year	Mean UAE For The Year
1978	$7.72 billion	$7.64 billion
1977	7.55	

1975	7.33	7.16
1974	6.93	
1970	5.53	5.41
1969	5.28	
1965	4.49	4.39
1964	4.28	
1960	3.49	3.40
1959	3.30	

We considered making similar computations of the UAE for industrial life insurance and individual annuity business. Rough estimates suggested that the magnitude of the UAE for these lines was likely to be insignificant in relation to the UAE for ordinary life. We therefore ignored these lines in computing UAE for the mutual segment, adding another measure of conservatism to our estimate.

ALLOWANCE OF A DEDUCTION FOR GROWTH.

Although our estimates of the UAE were added to mutual surplus to arrive at equity, for both statutory and tax accounting, policy acquisition costs are actually accounted for as current deductions. Accordingly, in estimating the taxable income of mutual life insurers as a segment, provision was made for allowance of a current deduction to be consistent with existing tax rules.

Allowing as a deduction acquisition expenses attributable to all business newly written for a year would, however, result in an excessive allowance. At least some portion of the business newly placed on the books replaces business already on the books that lapsed during the year of computation. A current deduction for the acquisition costs attributable to replacing the lapsed business is roughly the equivalent of the aggregate deduction for amortization that would have been allowed if, in the first place, all acquisition costs had been required to be capitalized and amortized. The equity return as calculated implicitly reflects a deduction for amortization of past issue years' acquisition expenses.

Consequently, allowance of a deduction against imputed return is appropriate only to the extent that business newly placed on the books during the computation year exceeds business that lapsed during that year. Thus, we ascertained the new annual premium for each computation year. We then estimated the amount of the premium attributable to all business on the books at the beginning of computation year which in fact was not received because of policy lapses during the year. To the extent that the new annual premium exceeded the estimated sum of the lapsed premiums, the new premium was considered attributable to growth. A deduction for estimated acquisition costs attributable to such growth was allowed.

Using 1978 for illustration, our estimate of the magnitude of the growth deduction was computed by subtracting from new annual ordinary life insurance premium for our ten company sample in 1978, $1.313 billion, the sum of an estimate (using the LIMRA lapse rates referred to above) of the inforce premium as of the beginning of 1978 that lapsed. This was estimated to be $812 million. The difference, $501 million, was taken to be the incremental new annual premium for 1978. This was multiplied by our 150 percent ratio of acquisition expenses to premium to arrive at an estimate of acquisition expenses attributable to new annual premium for the 10-company sample of $752 million.

Our estimates of the growth deduction, computed in this fashion, for other years are as follows:

1975 - $ 522 million
1970 - $ 318 million
1965 - $ 255 million
1960 - $ 228 million

EXHIBIT 1

Year	(1) Persistency Factor	(2) Present Value at beginning of year of Remaining Premium	(3) (2) x .24538 Remaining UAE Per $1 issued	(4) (3)/(1) Remaining UAE per $1 remaining
1	1.0000	5.1129	1.255	1.255
2	.8500	4.6720	1.146	1.349
3	.7650	4.2807	1.050	1.373
4	.7076	3.9156	.961	1.358
5	.6616	3.5672	.875	1.323
6	.6236	3.2290	.792	1.271
7	.5924	2.8949	.710	1.199
8	.5657	2.5607	.628	1.111
9	.5417	2.2239	.546	1.007
10	.5200	1.8817	.462	.888
11	.5005	1.5318	.376	.751
12	.4830	1.1713	.287	.595
13	.4673	.7977	.196	.419
14	.4533	.4082	.100	.221
15	.4408	0	0	0

Present value at beginning of year 1 at 8% = 6.1129 = 5.1129 + 1

Amortization per $1 of premium = 1.5/6.114 = .24538 including interest

EXHIBIT 2

Illustration of Computation of UAE for Ordinary Life, 12/31/78

(Does *Not* Reflect CRVM Adjustment)

Year	New Annual Premium	Persistency Factor	Premium Inforce	Amortization Factor	UAE
1978	1,311	1.0	1,311	1.255	1,644.8
1977	1,217	.85	1,035	1.349	1,395.2
1976	1,116	.765	854	1.373	1,172.3
1975	1,036	.708	733	1.358	995.4
1974	970	.662	642	1.323	849.1
1973	895	.624	558	1.271	709.1
1972	830	.592	492	1.199	589.6
1971	770	.566	436	1.111	483.8
1970	715	.542	387	1.007	390.2
1969	663	.520	345	.888	306.1
1968	630	.501	315	.751	236.8
1967	609	.483	294	.595	175.0
1966	593	.467	277	.419	116.1
1965	575	.453	261	.221	58.6
Total UAE					9,121.0

APPENDIX B

Estimates of Returns to Mutual Equity
(000,000,000's)

Item*	1960	1965	1970	1975	1978
1. A. Reported Statutory Surplus	$4.221	$ 5.311	$ 6.240	$ 5.794	$ 7.055
B. Mandatory Securities Valuation Reserve	.763	1.628	1.396	.588	1.775
C. Provision for Policyholder Dividends	1.184	1.810	2.318	3.038	3.833
D. Certain Non-Admitted Assets	***	***	***	.281	.402
E. Unamortized Acquisition Expense	3.40	4.49	5.53	7.39	7.64
2. Equity	$9.568	$13.239	$15.484	$17.091	$20.705
3. Pre-Tax Rate of Return**	.0833	.0810	.1342	.1519	.1608
4. Returns to Equity (2 x 3)	$ .797	$ 1.072	$ 2.078	$ 2.596	$ 3.329
5. Allowance of Deduction for Growth	(.228)	(.255)	(.318)	(.522)	(.752)
6. Taxable Income (4 - 5)	$ .569	$ .817	$ 1.760	$ 2.074	$ 2.577
7. Adjustment from Sample to Segment	÷ .7	÷ .7	÷ .7	÷ .7	÷ .7
8. Pre-Tax Equity Income (6 ÷ 7)	$ .813	$ 1.168	$ 2.514	$ 2.963	$ 3.682

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*/ Lines 1-6 are for 10 company sample; line 8 is for the mutual segment. Lines 1-2 are mean values.

**/ Rates for 1975 and 1978 are based on average rates on 7-year Treasury notes. Seven-year rates were unavailable for years before 1975. For 1960 and 1965 the rates on intermediate (3-5 years) and long-term (10 years and longer) Treasury securities were virtually identical and those rates were used. The 1970 rate is an unweighted average of intermediate and long-term rates. (Source: Federal Reserve Bulletin.) For years 1965, 1970, 1975 and 1978 the rate was divided by (1 - .48) = .52. For 1960 the rate was divided by (1 - .52) = .48.

***/ Non-admitted assets not computed for these years.

APPENDIX B, cont'd

Estimates of Tax
(000,000,000's)

Item*	1960	1965	1970	1975	1978
1. Taxable Income	$.813	$1.168	$2.514	$2.963	$3.682
2. Corporate Tax (at 52% for 1965; 48% otherwise)	.423	.561	1.207	1.422	1.767
3. Income After Tax (1 - 2)	$.390	$ .607	$1.307	$1.541	$1.915
4. Distribution percentage (statutory dividends ÷ statutory gain from operations)	71.00	72.38	76.71	75.26	65.66
5. Assumed Distribution (3 x 4)	$ .277	$ .439	$1.003	$1.160	$1.257
6. Individual Tax (at 25%)	.069	.110	.251	.290	.314
7. Total Tax (2 + 6)	$ .492	$ .671	$1.458	$1.712	$2.081

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*/ Data for mutual segment; except 4, which is based on 10-company sample.

Chairman **Stark**. Thank you very much.

Mr. Rolland, in your testimony you talk about the 10-pay problem, and the problem of converting older, lower, interest contracts to a more competitive contract. If in fact we altered our present outline and exempted, so that the 10-pay restriction would only apply to newly insured contracts, had indeed a constant premium converted into a newer form of contract, would be exempt from this restriction, wouldn't that technically resolve your objection?

Mr. **Rolland**. Defining some special rules for rollovers?

Chairman **Stark**. If you roll over an old contract with a 3-percent contract, as long as you keep the same premium?

Mr. **Rolland**. That certainly would be a step in the right direction.

Chairman **Stark**. I merely ask that question and I anticipated the response because this is exactly the kind of—I anticipate that there will be dozens of glitches that we have no intention, that we would like to correct. We are aware of those glitches and we are becoming more and more aware, and as we get this procedure refined, we anticipate that obviously more questions will come about. You can't rewrite a tradition of 25 years and not find things will get overlooked.

I merely say that, I hope this is an example of the type of problem that we anticipate that your very able technical people and our staff will be able to resolve within the overall framework.

Mr. **Rolland**. We certainly appreciate that and I think we have a body of experience that would help in dealing with that.

I would make one comment about the newly issued policies, and our studies indicate that the 10-pay life rule would impact there as well and it looks like about 10 percent of our new issues of universal life contracts would be adversely affected by the 10-pay rule.

Chairman **Stark**. By 10 percent?

Mr. **Rolland**. Yes, about 10 percent. There is an issue even on new policies that needs to be addressed. We don't see evidence currently in the market——

Chairman **Stark**. If we got to 8 years, would it be 8 percent?

In a sense, there is room in all of these numerical selections, whether it is 250 percent in the corridor, or whether it is 10 years and while there may be some symmetry in 10 years, which we use in other areas of the Tax Code, I would just like to assure the industry that any more than 25 percent or the 25 percent is the adjusting factor are merely numbers that we had to start with to get some idea where this structure would come out.

We anticipate that those numbers will change very much over the course of the next month.

Mr. **Rolland**. OK; appreciate that.

Chairman **Stark**. Mr. Lebed, I appreciate your testimony, and anticipating some other testimony, can you give me or is there a standard that you would say applies as to the dividend policy of stock life insurance companies? In other words, would you say there is a very narrow range, 40 percent of earnings, let's take the 50 largest stock companies.

Mr. **Lebed**. What percentage of earnings are paid out in the form of dividends? If I had to pick a number, I would say probably 35 percent.

Chairman **Stark**. Would you say that that is a fairly tight distribution or that it varies all over the lot?

Mr. **Lebed**. I would say it varies all over the lot.

Chairman **Stark**. So that if the mutual company set a fairer rate to get at that 23 percent we would take your dividend pay out. We are merely saying OK; we are dealing with 30 percent of the earnings rather than all the earnings. We are just adjusting the number. We are not making it any more or less?

Mr. **Lebed**. That is an entirely different concept, and I think an entirely inappropriate one. May I comment?

Chairman **Stark**. Sure you may.

What I am trying to get at is that the 23 percent or whatever that percent is, the end result is the balance. I guess this is my question: Really, would you care what that estimated rate of return was if we, for example, said "we will double the capital and cut the rate to 12 percent," and we will still come out with the 60-40 balance?

Mr. **Lebed**. I would certainly agree that the most important outcome is the combination of the rate and the base.

Chairman **Stark**. To what end, to the goal of an acceptable balance?

Mr. **Lebed**. In working out any proposal, you can look at the rate, the base and the combination of the two and the combination of the two is the most important thing.

Chairman **Stark**. To get to where?

Mr. **Lebed**. To determine if it is a reasonable result.

Chairman **Stark**. A reasonable result would be determined in a balance between the tax burden born by the segments of the industry?

Mr. **Lebed**. No, I think the result is, to say, a return equivalent to returns to owners in equivalent businesses?

Chairman **Stark**. Given two choices, the reason for going through all these gymnastics, I believe, is to get a reasonable balance between the amount of tax paid by the mutual segment of the industry and the stock segment of the industry.

I would think that is the paramount concern.

Mr. **Lebed**. That is another issue certainly.

Chairman **Stark**. Now, is that more important, or is having the correct philosophy more important? Let's assume that we get some philosophy that sounds great, but it comes to a 90/10 split. Are you ready to hang yourself on the tar of the philosophy, or would you prefer an equitable balance?

Mr. **Lebed**. No. I think there should be an equitable balance but also a sound structure, because the structure will determine what happens over time.

The balance we can only measure in the first instance, and I really would be hesitant to generalize and say one is important and the other is not.

Chairman **Stark**. Do you think it makes a whole lot of difference as between companies, say, on the stock side for a minute? Well, do you think it makes any difference whether we say we are going to value the equity or the imputed equity based on market value of the assets or on book value? That is, if you assume under market value you must impute some going concern, for instance, a value to the business on the books which usually isn't stated in the balance sheet?

Mr. LEBED. That is a fairly technical question, Mr. Chairman. I would prefer to submit an answer to that later.

Chairman STARK. My guess is, if you hold to book value, you are going to get some differences between companies. If you put that over and go to market value, other companies are going to be disadvantaged. I would suspect there is not much advantage one way or the other.

Mr. ROLLAND. Could I comment on that?

I think it would be well for the committee to try and construct an equity base for mutual companies that is reasonably comparable to the equity base calculated for stock companies and we operate under the accounting rules rather specifically defined how we calculate our equity and you can take a look at that and figure out how that applies to mutual life insurance companies and come up with a reasonable result.

Chairman STARK. There does exist some accommodations that would make that somewhat difficult, for example, if you all are successful in retaining about, as a segment of the industry, what I understand is about $9 billion of phase III overhang without an immediate tax of $4.5 billion and I am not suggesting that that is likely, you have been given something that has accumulated over the years.

Perhaps there are some mutual companies that may have a great deal of surplus accumulated over the years without benefit of ever having paid income tax on it, it may create some distortion within that segment of the industry.

This is purely my own personal sense, those are distortions that ought to be taken care of in the transition, and then prospectively let everybody play in the same, under the same rules. Any comment on that approach to it?

Mr. LEBED. No, that seems OK.

Mr. ROLLAND. It seems to me that makes sense.

Mr. LEBED. As I think more about this question of book value versus market value, I can see many cases, in which the use of market value would produce an answer that says there is no equity in this business. I don't think that is what you want to do.

Mr. ROLLAND. It is true that stock company equity is calculated based on book value of the fixed income assets that we carry.

Chairman STARK. Mr. Duncan.

Mr. DUNCAN. I have no questions. Thank you, Mr. Chairman.

Chairman STARK. Mr. Guarini.

Mr. GUARINI. Yes, Mr. Rolland, you addressed yourself as to the 80 percent of a stock company owned by a mutual company and how it should be taxed.

Did you say that you would prefer that it be reduced to a 50 percent level, is that correct?

Mr. ROLLAND. I believe that was Mr. Lebed's testimony.

Mr. GUARINI. Do you agree with that, Mr. Rolland, or do you have any particular position?

Mr. ROLLAND. Well, I would say this, that I think if you come up with a proper basis for taxing both stocks and mutual life insurance companies, that the issue of how you tax stock subsidies of mutual companies becomes relatively unimportant, because mutual companies will not be motivated to develop business in stock subsidies.

We operate a number of affiliates, and I can tell you that operating an affiliate is a very difficult thing and can create some very difficult management problems, so you do not do that lightly, so in order for the mutuals to do that, they would have to have a strong reason, because of an inequity in the basic tax law to take that position so the important way to deal with that is to come up with a fair basis for taxing the basic companies.

Mr. **Guarini**. The 80-percent level would be agreeable with you?

Mr. **Rolland**. I think that ought to be examined. I would prefer to work for a fairer and more equitable basis of taxing the basic companies, and then I really do believe that becomes a relatively unimportant issue.

Mr. **Guarini**. You share that view, Mr. Lebed?

Mr. **Lebed**. No. I think that the concepts that we are dealing with under this proposal are all very new, and it will be really several years before all the implications will be understood.

I think that to not worry about stock subsidiaries and mutuals under this particular concept would leave a lot of worry about whether the door is open to find ways to get out of what the bill is really designed to do. The reason we proposed 50 percent is that when you own 50 percent or more of a company, you control it.

Mr. **Guarini**. You could always have a situation where several mutual companies could hold 40 percent each of a stock company and there would be a lot of ways of getting around the rules so maybe there would be no real reason for having a rigid rule of this sort.

Mr. **Lebed**. Well, the objective should be to try to prevent all of those kinds of game playing and manipulation that would produce unintended poor results.

Mr. **Guarini**. Let me ask in regard to State taxes; nothing has been said, but it is my understanding that you all must comply with State laws and you have State taxes to pay. There are also premium taxes. Could you comment on how these proposed changes would affect the State taxes that you would have to pay because these must have an impact on the industry as well?

Is there a problem out there or can you comment on how State taxes would be affected by the proposed Federal changes?

Mr. **Rolland**. Well, I am certainly no expert on this. My judgment is that it would not have a significant impact on State taxes. We are taxed at the State level primarily on the basis of premium taxes. Those rates are set by the States, and I think are fairly independent of any Federal income tax we pay, so I do not see much relationship between what happens in terms of Federal taxes, and the ones we pay at the State level.

Of course, unless you impose on us a tax burden that makes it difficult for us to compete and our business is hurt, that would in turn drive down our business and affect State tax revenues but other than that, I don't see any relationship.

[Additional information follows:]

EFFECT OF STARK/MOORE PROPOSAL ON STATE TAXES

The net effect of the Stark/Moore federal income tax proposal on state taxes would be relatively small. This statement is based on a comparison of the Stark/Moore proposal with the 1959 Act (including the permanent modifications under TEFRA). A brief summary of the affected states follows:

INDIANA

Gross Income Tax—No effect.
Adjusted Gross Income Tax—No effect.
Supplemental Net Income Tax—Would increase in the $25,000 to $30,000 range.

FLORIDA

Net income tax paid to Florida would increase but additional tax would offset premium tax with no added cost to the company.

ILLINOIS

Same as Florida.

Other states where we file income tax returns are based on laws totally independent of the federal law and should not be affected.

Mr. GUARINI. Mr. Lebed, do you see any impact that the Federal taxing law would affect or have on the States?

Mr. LEBED. On State taxes, I just got a little advice from my experts and they tell me that the impact should be quite small.

Mr. GUARINI. It doesn't affect the mutuals more or less than the stock companies?

Mr. LEBED. That is correct. It does not.

Mr. GUARINI. How would your respective companies fare taxwise under the new proposal as opposed to the 1959 law? Can you compute the income taxes that you would be paying under the new system?

Mr. LEBED. We estimated what we actually incurred for 1982 and how that would relate to what this bill would produce in 1984 and in the case of Connecticut General Life we incurred roughly $64 to $65 million in 1982, and it would be just about double that in 1984 under the Stark-Moore proposal.

Your question was how would it have related to the 1959 act which was not in effect in 1982.

Mr. ROLLAND. I do not have with me the tax that we would have paid under the 1959 laws.

I testified that our taxes would have about doubled as related to the TEFRA stop-gap bill.

I believe there would be an increase in our taxes over the 1959 law but I am not aware of the magnitude of that and would be glad to furnish it.

[Additional information follows:]

LINCOLN NATIONAL CORP. TAX DEPARTMENT

AUGUST 5, 1983.

To Mike Marchese.
From: Jerry Young.
Subject: Comparison of LNL's Federal Income Tax Under Stark/Moore With 1959 Act.

For this purpose the tax under Stark/Moore includes 10 percent of the 818(c) adjustment and 10 percent of the difference between current reserves and cash value reserves. The tax under the 1959 Act takes into account the permanent modifications under TEFRA (repeal of Section 820). In both cases the tax is based on 1982 operations.

Stark/Moore Proposal, $40.9 million; 1959 Act, $34.3 million.

If you need more details, let me know.

JERRY YOUNG.

Mr. LEBED. I do have the information here. In 1982, under the 1959 act, our taxes would have been slightly higher, maybe $5 million higher, call it $70 million and in 1984, we estimate under the 1959 act, they would be $95 million as opposed to something like $125 or $130 million under the Stark-Moore proposal.

Mr. GUARINI. Lastly, in this differential rate between the mutuals and the stocks, are you satisfied that there is a fair balance struck there?

Mr. LEBED. In the Stark-Moore proposal? Yes, our estimate is that that proposal would produce revenues that would be split 59 percent by the mutuals and 41 percent from the stocks and the position of my company and most of the companies that I am speaking for has consistently been that something like 60/40 is the appropriate ratio.

Mr. GUARINI. Do you share that opinion?

Mr. ROLLAND. I don't think there is any right true answer on that issue.

There are varied opinions on it. You can use different measures of the distribution of business in our industry and come up with results.

I do believe, though, that the tax on mutual companies should be over 50 percent of the total and the tax on stock should be less than 50 percent of the total. Where you come out in terms of the exact percentage, I think, is a matter of individual choice. I may not get all the way to 60/40, but I am not far off.

Mr. GUARINI. You are not concerned about the competitive edge as the bill is presently written?

Mr. ROLLAND. No, I am not.

Mr. LEBED. The main concern as far as competitive problems with the current bill is that it greatly weakens the competitive position of the entire industry with regard to other financial institutions.

This bill would produce a reasonable, competitive balance.

Mr. GUARINI. Between the stocks and mutuals, there is no big problem, as you see it?

Mr. LEBED. We have said that there are certain things we would like to see changed, most of which would have a relatively even impact on the stocks and mutuals, and if that were the case, then the balance would still be a reasonable one. If it turns out that those changes help stocks more than mutuals, or vice versa, probably there needs to be some further adjustment.

Mr. GUARINI. All right. Thank you, sir.

Chairman STARK. Mr. Flippo.

Mr. FLIPPO. No questions.

Chairman STARK. Mr. Schulze.

Mr. SCHULZE. I have no questions, Mr. Chairman. Thank you.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, I have a brief question.

Mr. Lebed, toward the end of your testimony when you discussed policy loans, you opposed the $50,000 limit, and you talked about the possibility of a prospective application of whatever determination this committee would make. Would you amplify on that and how it would affect existing policies, existing agencies and policyholders?

Mr. **Lebed**. First, I think you are going to hear substantial further testimony on this and would ask you to rely heavily on that.

It has been our feeling that the $50,000 limit is unnecessary, doesn't accomplish that much.

We look, for example, at our own business and find less than ⅓ of 1 percent of loans come anywhere close to that so it is a very small percentage.

We also feel strongly that if the Congress in its wisdom feels that there does need to be some kind of limitation, it should not be applied to business already in force. People bought those contracts in good faith under a set of rules and we would think they should continue.

Mr. **Dorgan**. Are there abuses in any area that would lead you to conclude that some remedy needs to be addressed by this committee?

Mr. **Lebed**. My own personal opinion is that there probably are a few abuses going on but not enough to be a problem of concern or to require legislative action.

Mr. **Dorgan**. Mr. Rolland.

Mr. **Rolland**. I would say that is right. The fact that there are so few policy loans over $50,000, our experience would mirror the Connecticut General's and would indicate that this is not a serious problem. It is hard to say there are absolutely no abuses going on in the marketplace, but I would think there is clear evidence that they are not of importance.

Chairman **Stark**. Mrs. Kennelly.

Mrs. **Kennelly**. I gathered you had at least two basic changes in the proposed life insurance reserve systems, but I didn't quite catch what they were.

Mr. **Rolland**. All right. There were actually three changes. The first is that we would propose that the new reserve bases be based on the commissioner's reserve valuation method.

Second, we believe rather than using, say, the weakest standards in any State requirements, that companies be permitted to use mortality and interest assumptions that they carry in their reserves for their annual statement purposes. Those are statements they file with State insurance departments.

Then, furthermore, we believe that the question of the reserve overhang needs to be dealt with and that is a matter of extreme importance. We do not believe that it is fair to force us to bring back in income over 10 years the difference between the old and the new reserve bases.

It is particularly true when you take into account that some companies never had the opportunity to even use those reserve deductions in the past. They very likely would be taxed on them in the future and that seems clearly unfair.

In addition, as you look to the future, under the Stark-Moore proposal, that flowback of those reserves and the income would have relatively little impact on the mutual segment of our business. It would fall most heavily on the stock side.

Mrs. **Kennelly**. You referred to the commissioner reserve valuation method.

Do you prefer that rather than the Stark-Moore because it alters revenues, or do you like the way it is computed?

Mrs. **Rolland**. Well, it is an accepted reserve standard.

It is permitted as the reserve basis, I believe, in all States, whereas the full preliminary term is not.

It is used generally throughout the industry. We simply think it makes a lot more sense. It is very little different, I believe, in terms of its magnitude, revenue impact from the impact of using full preliminary term.

Mrs. **Kennelly**. Toward the end of your testimony, you emphasize that you have problems with the Stark-Moore guidelines and definition of a life insurance policy. We have heard a lot of discussion about this over the last week, and I have had people say to me that the guidelines in Canada are much stiffer than the guidelines in Stark-Moore. I assume you sell insurance in Canada. How can you live with those and not with these?

Mr. **Rolland**. We do have an affiliate that operates in Canada and I pretty much let them alone to do their business so I can't profess to be an expert on their situation.

Mrs. **Kennelly**. The comparison is not a legitimate argument?

Mr. **Rolland**. I don't think what they do up there is relevant to what we do here. We have tried to analyze the impact of these rules on our business here in the United States, and we think they have a very serious impact on business that we regard as truly life insurance business, and we are saying in this area, what you ought to try to do is draft rules to prevent abuses, and we support that fully.

We think it would be a mistake, however, to draw rules so tightly that they prevent us from selling legitimate life insurance contracts. We have analyzed our universal life business which we have written over the last year and a half, and we think these rules would have a very serious impact on what is really legitimately life insurance business.

Mrs. **Kennelly**. Thank you, sir.

Mr. Lebed, am I correct that there is some confusion as to what reserve standards apply to business other than ordinary life and individual annuities, like pensions? Is this a concern?

Mr. **Lebed**. That is a very important and very good question.

The proposal deals only with individual life insurance, and other products, such as group life insurance, pensions and so forth and quite a few others just have not been dealt with yet. Those are highly technical subjects, and I think that we can be of help to the staff in working out appropriate reserve standards for those. We would clearly like the opportunity to do that.

We do feel that wherever there is an overhang situation created, that the principles of a fresh start approach should be applied, regardless of the product.

Mrs. **Kennelly**. You heard the chairman and I discuss phase III overhang, because I am concerned about it.

You heard what Mr. Chapoton said about the four proposals in our pamphlet. We agree that possibly forgiveness is the right way to go. Could you say why this is important to you.

Mr. LEBED. Yes, you are talking about the phase III account. Our position is that those accounts should not be taxed in the future if there is a new life insurance tax act. We have paid our fair dues in the past and we will in the future and the additional burden of paying taxes under the old law doesn't seem fair. It does apply only to stock companies which creates balance problems and it seems inequitable relative to the way Modco was treated, and it would be a substantial problem for most companies.

I did say if there would not be a complete forgiveness approach that option 4, which says treat it the same as under the 1959 act, was the only realistic possibility.

Mrs. KENNELLY. You could live with the freeze?

Mr. LEBED. With some pain, but we really don't think that is the right answer.

Mr. GUARINI [presiding]. Mr. Moore.

Mr. MOORE. I thank you for being here this morning and testifying. We are also concerned about the transition rule and will be looking at it just like we look at every portion of the bill.

Mr. Rolland, in listening to the problem that you outlined—10-year deferred annuities—would you please submit for the staff more detailed information. We need data. We don't have that in the data banks of Treasury or the Joint Taxation Committee.

Mr. ROLLAND. I have some of that information with me and would leave it with you.

We will develop additional information and refer it to you.

Mr. MOORE. I have no further questions. Thank you both for being here.

Mr. GUARINI. Mr. Jenkins.

Mr. JENKINS. Thank you. I want to apologize to the panel for not being able to hear your testimony. I had another meeting I had to attend.

I have attempted to briefly go over part of the testimony and I will read it in full a bit later.

I want to direct a couple of questions to Mr. Lebed. You indicate some concern about the treatment of the smaller companies under the proposal. Do you feel that there will have to be some considerations made for the very small insurance companies?

Mr. LEBED. Yes, absolutely.

Mr. JENKINS. As I understand it, if there is an elimination of any preliminary term reserve, or reevaluation, that will definitely disfavor smaller companies, since many of them do not have the surplus to fully fund the net level premium reserves. Is that right?

Mr. ROLLAND. I think as a general proposition, that is true.

Certainly smaller companies have much more limited surpluses and therefore really need to set up minimum reserves.

I do think, though, you will find that that practice of using minimum reserves is now rather widespread in the industry, and limited surplus and judicious use of surplus is a problem that companies face of all sizes.

Mr. **Jenkins**. I would assume, Mr. Lebed, that the original purpose in the 1959 act was to attempt to equalize this situation with the smaller, less mature companies. Is that correct?

Mr. **Lebed**. That is exactly right.

Mr. **Jenkins**. It appears to me from listening to the testimony of the mutuals and the larger stocks and from talking with them, that there is agreement that there will have to be rather substantial relief for the smaller companies, if they are to remain in business and competitive. Do you agree with that?

Mr. **Lebed**. Certainly.

Mr. **Rolland**. We are fully in support of that idea. I think it is important that smaller companies have special tax arrangements, and it would help them compete with the larger companies that have more resources.

Mr. **Jenkins**. Mrs. Kennelly has expressed her concern about the treatment of the reserve overhang.

If I understand your testimony, you feel that there should be no taxes paid on this overhang.

Mr. **Rolland**. Our position is that reserves should be marked to the new basis in 1984, and that, therefore, from that point on, we have a fresh start and taxes be determined on the new basis solely for the future. Our position is it would be unfair to do otherwise, because many companies have not had the benefit, because of their tax situations, of these reserve deductions in the past, and it would be unfair to tax them in the future on deductions they have really not gotten, and there is also an uneven impact between the stocks and mutuals arising from the idea that these ought to flow back into income over a 10-year period.

We think the fairest way to the entire industry is to have a fresh start under a new law, a new approach, and to mark the reserves with the new basis.

Mr. **Jenkins**. I assume we will hear from mutual companies today that will be particularly concerned about the 23-percent figure, as well as about what makes up the base upon which that 23 percent is applied.

You have examined the computations that go into the base figures.

Are there items included within that base that you think ought to be eliminated?

Mr. **Lebed**. This is relative to the computation of return on equity?

Mr. **Jenkins**. Yes.

Mr. **Lebed**. We think the definition of the base in the Stark-Moore proposal is a reasonable one.

We had submitted some views to the staff in which we would have included more items in the base than have been included.

Mr. **Jenkins**. What about the items that are included which will be paid out within a short period of time for the policyholder?

Mr. **Lebed**. Liabilities for dividends?

Mr. **Jenkins**. Should they be included?

Mr. **Lebed**. I think the present tax law recognizes that liabilities can be set up for dividends that are not paid out in fact, and our position simply is that same principle should apply here.

Mr. **Jenkins**. I know my time is up, but let me ask you one further question on the $50,000 limitation on borrowing from or on a policy.

If that provision is kept in the proposed legislation, I do not know what restrictions would be placed in there to prevent an end run with such a limitation. It appears to me at first glance that a person could take his policy and go to a bank or some other lending institution, make a loan and get full deductibility of interest whereas he could not if he borrowed directly from the company.

Have you looked at that?

Mr. **Rolland**. I think that is a concern, and furthermore, they would probably get a larger tax deduction by doing that because they would be paying more interest than they would on their policy loans.

Mr. Lebed and I both testified that in both of our companies, there are virtually, there are very few loans over $50,000. Therefore, we really view this as an area where there may be some perceived abuse and probably is some but it is certainly not significant, and we doubt that trying to impose this will accomplish very much, and certainly, if you do impose it, we think it ought to be prospectively only, and the $50,000 limit ought to be looked at very carefully.

Mr. **Jenkins**. That item is of more concern to the agents out in the field?

Mr. **Rolland**. You will hear from others on that subject.

Mr. **Jenkins**. A lot of the people in my part of the country have financed home construction in this manner. I wonder if this limitation would preclude the deductibility of interest on these home loans?

Mr. **Rolland**. It is my assumption that if money were borrowed from a life insurance policy, it would be subject to this restriction no matter what the money was used for.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Chairman **Stark**. I wish to thank the panel for their contribution and help over the past several months and the help of your colleagues in your segment of the industry.

Our next panel representing the mutual life insurance segment of the industry consists of Robert V. Van Fossan, chairman and chief executive officer of Mutual Benefit Life Insurance Co., and Mr. Robert A. Beck, chairman and chief executive officer of the Prudential Insurance Co. of America.

We also have present a list of gentlemen, and I wanted to single out Don Ricketts, Matt Zinn, Ted Groom, and Harry Garber, who have spent many hours closeted in our quarters here working with the staff, and it would not be fair to ignore on the stock side, Bill Harman, Tad Davis, Dave Pustilnik, and Quincy Abbott, who have labored long and hard for the stock companies.

Their technical expertise and patience have been of tremendous benefit to the Chair, the members of the subcommittee, and the staff. I want to say it is an unusual procedure to work the way we have, but they have given us the time to try and learn the vocabulary, and we appreciate the work that the third lobby, the third house, has contributed in this instance.

Bob Van Fossan, and Bob Beck, proceed in whichever order you are comfortable.

Without objection, your entire statements will become part of the record.

STATEMENT OF ROBERT V. VAN FOSSAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE MUTUAL BENEFIT LIFE INSURANCE CO., AND CHAIRMAN, MUTUAL COMPANY EXECUTIVE COMMITTEE

Mr. **VAN FOSSAN.** I am Bob Van Fossan, chairman and chief executive officer of the Mutual Benefit Life Insurance Co.

I appear before you today in my role as chairman of the Mutual Company Executive Committee, representing all mutual companies.

As you know, this group was formed to provide a focal point for formulating mutual company positions on permanent tax legislation.

First, let us, too, commend the efforts of the chairman, Representative Moore, and other members of the subcommittee and staff, to develop permanent legislation for taxing life insurance companies. This new legislation, we assure you, is critically needed to replace the current complex inequitable structure.

Moreover, I want you to know that we appreciate the concern expressed by the subcommittee as well as by staff, that the final legislative product be simple, be rational, and be fair.

We believe the proposal is an important first step toward this goal.

As chairman of the mutual company group, let me assure you that we agree totally with the basic thrust of your proposal; that is, to develop a single-phase system to tax all life insurance companies on their true economic income. The proposal does away with many of the irregularities and distortions contained in the 1959 act.

The objective of the proposal, however, we would suggest, is undermined by several serious technical flaws.

These flaws prevent the proposal from achieving its goal of taxing economic income. Indeed, the flaws threaten to introduce major new artificialities in place of those contained in the 1959 act.

While my own written statement, together with the mutual companies' statement on life insurance company tax legislation, which have both been submitted, outline in detail our comments on the proposal.

I should like to speak briefly to our major concerns as covered in both of those statements.

Let me begin with the proposal's approach to the ownership differential between stocks and mutuals. Mutual companies accept the practical need for an ownership differential mechanism. There is, however, a considerable difference of opinion as to whether this goal can be achieved by a law which addresses the issue by a minimum tax on surplus.

This is particularly true when, for many, if not most, mutual companies, this would be their sole basis of taxation.

Some companies believe that a surplus-based tax is inappropriate because it would not tax economic income, but rather would be an excise tax on surplus.

Most mutual companies believe that a better way to recognize ownership differential would be by limiting the deductibility of dividends.

We would suggest, however, Mr. Chairman, that these two positions can be accommodated within the framework of the committee's proposal.

This could be done, we suggest, by using a surplus based approach to mathematically determine the appropriate uniform percentage limitation on dividends for all mutual companies.

We would then further suggest that the legislation be written so as to enable Treasury to periodically update the percentage rate applied to our surplus or equity base.

The law would provide that this update would be made on the same basis as the committee's original recommendation.

Mr. Chairman, let me emphatically state that all mutual companies, however, are in agreement on one point: That the specified surplus interest computation contained in the proposal is totally unacceptable.

The tax on surplus approach defeats the proposal's goal of developing a single-phase tax on economic income.

For stock companies, the proposal does provide, in fact, a single-phase system. All items of income and deduction are taken into account. No items of deduction are limited, and a full deduction for dividends paid to policyholders is allowed.

For mutual companies, however, the proposal provides really three alternative tax bases.

Most mutual companies would be taxed on the surplus-based tax. Some others would pay a tax on gain from operation with no deductibility for dividends.

Others would be taxed on their gain from operations with a full or partial deduction for dividends.

In sum, the proposal fails in its objective to create a single-phase tax system.

Let me then turn next to the specific mechanics of the proposal that we feel must be addressed even if you were to accept our recommendation of using the earnings on equity approach to determine the appropriate level of dividends deductibility.

First is the rate of return on equity, the 23 percent contained in the proposal.

The proposal applies a totally unrealistic rate of return to mutual company surplus.

Rates of return earned by industrial corporations should not control in determining a reasonable rate of return to be earned by a mutual company. The grossed-up T-bill rate is unreasonable since invested assets cannot earn a grossed-up T-bill rate. There is also concern over using past or current rates of return earned by stock life insurance companies.

The rate earned by stocks in recent years is unusually high, primarily because the interest rate they have earned was much higher than the interest assumption used in the pricing of their old nonparticipating contract. Stock company earnings, we suggest, on interest-sensitive products such as universal life will be much lower.

If the proposal is to achieve its overall objective, that is, to tax economic income, then the determination of the rate to be used is of paramount importance.

While, our intuitive reaction is to suggest our own individual company portfolio rate, we realize this may be inappropriate. However, in no event should the rate be greater than the aggregate rate earned by stock companies.

Next, the restated surplus or equity base contained in the proposal is overstated. The formulas contained in the proposal have the effect of doubling the statement surplus for most mutual life insurance companies. In the case of my own company, Mutual Benefit, our yearend 1982 statement unassigned surplus was $178 million.

The proposal resulted in an adjusted surplus base of $406 million. The proposal adds the reserve for declared dividends, mandatory security reservation reserve and nonadmitted assets to statement surplus.

We frankly believe each of these add-ons is unjustified. It is important to the proper operation of any ownership differential that mutual company equity is computed in exactly the same manner as stock company equity.

Under the proposal, statement surplus is increased by adding the difference between statement and tax reserves; that is, minimum reserves required by State law or cash surrender value, or greater.

It is generally agreed that one of the basic flaws of the 1959 act was the extensive use of special deductions and adjustments to statement reserves.

We would hope that to the extent possible, we not make that same mistake again.

Next, treatment of tax preference items: Under the proposal, stock companies would continue to receive preferential treatment on a number of items such as the company share of tax-exempt interest and dividends, accelerated depreciation, particularly on real estate, market value discount and capital gains.

Most mutual companies, however, would not receive this treatment, because the proposal's return-on-equity minimum does not reflect tax preferences.

Hopefully we can all agree, as was suggested by Secretary Chapoton this morning, that stocks and mutuals must receive equal treatment in this important area.

The net effect of these items, if not changed, are graphically illustrated in the chart to my right.

As you can see, in the left-hand column, the mutual companies presently have 39 percent of total industry equity as measured on a statutory basis.

The restating of surplus as done in the Stark-Moore proposal increases that to 49 percent of interest equity.

The proposal would result in the mutual companies paying 63 percent of the tax.

Stock subsidizing of mutual companies—the proposal suggests applying the ownership differential not only to mutual companies, but also to stock subsidiaries of mutual companies.

We would suggest that this is totally inappropriate. The proposal's stated justification for applying the differential initially to a mutual company is that the company's customers are also its owners. This very justification, it seems to me, would logically preclude applying the differential to a stock subsidiary.

The subsidiary is owned by the mutual company parent, not by the policyholders of the subsidiary.

A comment on the treatment of small companies: The mutual companies support the goals of the committee in trying to find the appropriate level of relief for small companies. While there is no exact answer to this issue, either in defining what is a small company, or in defining the appropriate level of relief, the objective we feel should be to encourage the continued growth of small companies. They really benefit all of us as well as the public in the long haul.

Before turning to the specifics in the proposal relating to the taxation of individual policyholders, let me comment briefly on the understandably controversial area of the phase III deferrals.

Surplus accounts of stock companies reflect amounts on which tax has been deferred under the 1959 act. Thirty-plus years of experience, we feel, has demonstrated that these deferrals simply have not been justified.

For this reason, mutual companies support your proposed option in the proposal which provides that the amount of phase III deferrals in the surplus amount of stock companies should be taken into income pro rata over a period of time.

Definition of life insurance: We believe that the proposed definition is fair and reasonable. Tax treatment of life insurance should not be available to investment contracts with only a thin veneer of life insurance.

Both alternative 1 and alternative 2 apply meaningful tests which we feel are of comparable stringency. Adopting this definition will create a level playing field for those policies which do qualify as life insurance.

The proposed definition should, however, we feel, be modified in one respect in order to assure fair competition among all life insurance products. As drafted, the proposal treats excess interest accumulations much more favorably than it does dividend accumulations.

As the two types of accumulations are economically equivalent, competitive equity and economic neutrality require a change to extend the favorable tax treatment to dividends so long as the underlying contract meets your proposed definition of life insurance.

Mr. Chairman, while I had not planned on doing so, I would like to take a moment to comment just briefly on some comparisons that have been made earlier of traditional participating life insurance with an array of products which are commonly referred to as universal life.

The statement was made by those testifying in the preceding panel that universal life insurance is new, it is innovative and it is consumer oriented as compared with traditional life insurance. Universal life products that meet the proposed definition of life insurance, I would suggest, are nothing more nor nothing less than participating life insurance issued by stock insurance companies.

It is neither new nor innovative. The universal life phenomena simply reflects the realization by stock companies that for the consumer, a participating product is a better deal than a nonparticipating product in which by definition the consumer does not participate in the company's current high interest return.

Frankly, I had a great deal of difficulty with the arguments made in favor of changing the subcommittee's proposed definition of life insurance. On the one hand, the argument was made that there must be a premium guideline test if universal life is to compete on an equal footing with traditional life insurance.

On the other hand, they propose changes in the minimum risk corridor on the basis that you should not force universal life insurance into the same mold as participating life insurance.

It does not seem to me that you can have it both ways. Either the rules are going to be the same for all life insurance products or they are not.

Simply stated, we regard the universal life phenomenon as basically a recognition by the stock companies of what many of us have felt all along, that the participating life product is the most consumer-oriented product that has been designed.

Computation of investments in the life contract: Your proposal would amend the definition of investment in the contract to require that the pure term insurance cost be subtracted from premiums paid. The effect of this proposal would subject life insurance, a personal asset to a very unique treatment.

In the case of all other personal assets, no basis reduction is required for depreciation, nor is the taxpayer's basis reduced by the value of any personal benefit derived from the use of assets.

Unless and until the rules change for other assets, life insurance should not be singled out for discriminatory treatment.

A comment on the earlier discussed issue of policyholder loans. The proposal to deny interest deductibility on policy loans of $50,000 is, in our opinion, both unfair and perhaps impractical. It will not raise a significant amount of revenue but it will create many problems.

Moreover, this change would again affect only one form of appreciating asset, individual life insurance. Interest paid on loans secured by appreciated assets other than life insurance would continue to be tax deductible. In fact, as was suggested by Congressman Jenkins, a loan made at the bank with the life insurance policy put up as collateral would enable the sophisticated larger borrower to totally circumvent the restriction.

Mr. Chairman, we appreciate the efforts of you and other members to move this matter through the legislative process as rapidly as possible. Again, we feel and assure you that the need for new legislation is urgent to avoid reverting to the 1959 act, which has been so troublesome to you and to us.

We thank you for this opportunity to express our views, and would be happy to answer any questions either now or at the conclusion of Mr. Beck's testimony.

Chairman STARK. Thank you very much, Bob.

[The prepared statement follows:]

STATEMENT OF ROBERT V. VAN FOSSAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE MUTUAL BENEFIT LIFE INSURANCE CO.

Mr. Chairman and Members of the Subcommittee, thank you. I am Bob Van Fossan, Chairman and Chief Executive Officer of The Mutual Benefit Life Insurance Company. I am also Chairman of The Mutual Company Executive Committee, which was formed to provide a focal point for formulating mutual company views on permanent tax legislation.

Mr. Chairman, the mutual companies have been deeply impressed by the Herculean efforts expended during the last several months both by the Members of this Subcommittee and by the Congressional and Treasury staffs working with the Members. We are grateful for those efforts.

The Stark/Moore proposal represents a major step forward, but it must not be the end of the journey. We agree totally with the basic thrust of the proposal—to develop a single-phase system to tax insurance companies on their economic income. The proposal does away with many of the distortions contained in the 1959 Act. The objective of the proposal is undermined, however, by several serious technical flaws. These flaws prevent the proposal from achieving its goal of taxing economic income. Indeed, the flaws threaten to introduce major new artificialty in place of what is in the 1959 Act.

Mutual companies are united in their agreement with the goal of the proposal. There is, however, a considerable difference of opinion as to whether this goal can be achieved by any law which addresses the ownership differential issue by a minimum tax based on surplus. Many mutual companies believe that a surplus-based tax is inappropriate because it would not tax economic income, but would instead tax capital. Mutual companies believe that a better way to recognize the ownership differential would be by limited deductibility of dividends. We believe that these different positions can be accommodated by using a surplus-based approach to determine a uniform percentage limitation on dividends for all mutual companies. The law should also enable the Treasury periodically to update this percentage in the future. This update would be made on the same basis as the original percentage determination.

Mr. Chairman, let me emphatically state that all mutual companies are in agreement on one critical point—the particular earnings-on-surplus computation contained in the proposal is totally unacceptable. I cannot stress too strongly that the flaws in the current computation of the ownership differential are of such magnitude as to preclude mutual companies from supporting the proposal unless it is substantially revised.

OWNERSHIP DIFFERENTIAL

The central flaw in the proposal involved the implementation of the ownership differential. This implementation defeats the proposal's goal of developing a single-phase tax on economic income.

For stock companies, the proposal does provide a single-phase system. All items of income and deduction are taken into account; no items of deduction are limited; and a full deduction for dividends paid to policyholder is allowed to stock companies.

While stock company taxable income is tied in the first instance to economic income, the link between the two is broken by the provision allowing stock companies to reduce their taxable income by 25 percent of such income, resulting in their being taxed on only 75 percent of their economic income. As applied to stock companies, this tax adjustment resembles the non-economic special deductions of the 1959 Act, which distorted the stock company tax base.

For mutual companies, the proposal provides three alternative tax bases. Most mutuals would be taxed on the surplus-based tax. Other mutuals would pay a tax on gain from operations with no deduction for dividends. And it is even theoretically possible, though not likely, for some mutuals to be taxed on gain from operations with a full deduction for dividends. In sum, the current proposal fails in its objective to create a singel-phase tax base.

Most important, the current proposal does not produce a tax on economic income. Most mutuals would pay a surplus-based tax regardless of their true economic income. Items of income and deduction would have no significant tax effect for mutuals but would for stocks. The failure to tax economic income constituted the single most important flaw of the 1959 Act. The current proposal, in failing to correct this defect, is similarly flawed.

The proposed disparity of taxation for stocks and mutuals would wreak havoc with mutual companies' ability to compete. The impact of the proposed minimum base will show up in the pricing of mutual company products and, given the intensity of competition in today's marketplace, will result in reduced sales of those products. Several of my colleagues will give you some concrete examples of this phenomenon.

When products are competing head to head, the only way to treat them fairly is to tax them both in exactly the same fashion. Unless products are taxed the same, competition between them necessarily will be distorted.

I. If the equity or surplus of mutual companies is to be used in determining the appropriate level of dividend deductibility, several changes must be made in the basis of computation

A. The rate of return must be made realistic

The Stark/Moore proposal applies a totally unrealistic imputed rate of return to mutual company surplus. If the proposal is to achieve its overall objective, that is, to tax economic income, the most appropriate rate of return would be the company's own portfolio rate. This is, after all, the rate of return on invested assets which the company actually earns.

The rate of return which has been recommended (23 percent) is a composite rate which takes into account the rate of return on equity of stock life insurance companies and of industrial corporations. The composite rate also includes a grossed-up T-Bill rate factor.

Rates of return earned by stock life insurance companies should not control in determining a reasonable rate of return to be earned by a mutual company. The rate earned by stock companies in recent years is unusually high primarily because the interest rates they have earned were much higher than the interest assumptions used in pricing their old nonparticipating products. Stock company earnings on new interest-sensitive products such as universal life will be much lower.

Rates of return earned by industrial corporations clearly are irrelevant to life insurance company operations and should not be imputed to mutual companies. Finally, the utilization of a grossed-up T-Bill rate is unreasonable since invested assets simply cannot earn a grossed-up rate. Both of these last two rates should be eliminated to enable mutual companies to compete with stocks on a reasonable basis. We cannot hope to compete if we must earn more on equity than stock companies. It is perhaps a measure of how far wrong the existing proposal is that it contains an imputed rate of return for mutual companies (23 percent) that is 50 percent higher than even our stock company brethren have proposed.

An actual rate of return or portfolio rate of return on surplus is the only rate of return which makes economic sense. If, however, an imputed rate of return is to be considered, in no event should it be greater than stock company gain from operations as a percentage of stock company equity.

B. A mutual company's liability for policyholder dividends should not be included in the company's deemed equity

A company's equity consists of its assets less its liabilities. The current version of the proposal, however, includes in mutual companies' equity a substantial portion of the statutory reserve for policyholder dividends. Since the reserve represents a real liability of the company, it should be excluded from equity.

The 1959 Act and Stopgap both recognize the reality of the liability for policyholder dividends. Similarly, GAAP accounting requires that declared policyholder dividends be carried as a liability, not as a part of surplus. The AICPA's audit guide states, "A liability is established for dividends payable beyond the end of the accounting period if a commitment to pay such dividends has been made by board resolution." AICPA, Audits of Stock Life Insurance Companies 51 (2d ed. 1979).

In violation of this required accounting treatment, the proposal suggests an unprecedented, inappropriate analogue to the "all events test" of the tax law. The all events test itself is a departure from generally accepted accounting principles. The departure is justified on the theory that it is necessary in order more accurately to measure income for tax purposes. Here, however, the goal is to measure the company's equity—a balance sheet item, rather than an item of profit and loss. Provisions designed to measure equity should accept the best available estimate of a company's balance sheet liabilities. That estimate treats the reserve for policyholder dividends as a liability.

C. Other deviations from the annual statement should not be made

We also believe that surplus should be determined in a manner that comports with the company's required annual statement. Reserve liability should reflect the reserve actually held by a company. Moreover, it is inappropriate to increase statment surplus by nonadmitted assets and by the security valuation reserve, which is required by the state.

D. If there is a minimum tax base, it must be adjusted to allow fair competition in the marketplace

1. A Minimum Level of Dividend Deductibility Should Be Added in Order to Prevent the Minimum Tax from Shutting Mutuals Out of Interest-Sensitive Markets.—With increasing consumer sophistication, the market for excess interest products has become increasingly competitive. In today's interest-sensitive environment, disparities in tax treatment can keep tax-disfavored companies entirely out of such a market.

We have seen that happen. For instance, under the 1959 Act, many companies believed that excess interest was fully deductible by most stock companies but that mutuals received no tax benefit from their own deduction for such interest. As a result, the market for excess interest deferred annuities became the private domain of stock companies.

Under the Stark/Moore proposal, all stock companies would receive a full deduction for excess interest and for analogous post-issue price adjustments. The earnings-on-surplus calculation, however, will cause mutuals to lose some or all of their deductions for such flexible pricing features. If an ownership differential is needed and if a perfectly accurate differential is enacted, mutual companies will remain able to compete effectively with stock companies, even in interest-sensitive markets. But to the extent that the differential enacted is greater than a perfect differential, it will tend to make mutual products more expensive for policyholders than comparable stock company products. An additional provision is needed, therefore, so that the limitation on the deduction will not preclude mutuals from competing with stocks in the excess interest market.

Marketing authorities have established that a difference of 25 basis points in the interest rate is competitively significant and that any greater difference rapidly becomes an insuperable competitive obstacle. In today's economy, a 5% stock-mutual differential in dividend deductibility corresponds to a pricing advantage of 25 basis points in excess interest. Stopgap reflected a widely held belief that a deductibility differential greater than 7½ percent might unfairly disadvantage mutuals.

Accordingly, a minimum level of dividend deductibility should be added to the surplus-based limitation on the deduction of dividends. This would ensure that no company would have to much of its excess interest deduction denied that it could not compete in interest-sensitive markets. We believe that the proper level for such minimum deductibility is 92½ percent of dividends (the 100 percent that is deductible by the stocks, less a 7½ percent differential).

2. Mutual Should Be Given the Same Tax Preferences That Will Be Enjoyed by the Stocks.—The earnings on-surplus computation in the Stark/Moore proposal is based on a model that contains no tax preferences. Unlike that model, however, the Federal income tax today contains numerous tax preference provisions. Such preferences include interest on tax-exempt bonds, a portion of stock dividends, accelerated depreciation, and nonaccrual of market discount on bonds. The current version of the proposal would make these preferences available to all stock companies. But it would deny them to any mutual company whose tax liability is determined by the minimum tax base. To deny these preferences to those mutual companies is unfair to the companies, and the denial impedes the accomplishment of the policy goals that motivated the tax preferences in the first place.

3. A Cumulative Calculation Should Be Adopted in Order to Allow the Minimum Tax Provisions to Accommodate to Annual Fluctuations in a Company's Operations.—Although corporate operations will fluctuate from year to year, the minimum tax base will be much more stable. Thus, annual fluctuations in operations may result in a tax liability that is higher than that imposed by the minimum tax in one year and lower than that imposed by the minimum tax in the next. In that second year, there ought to be some recognition of the taxes beyond the minimum taxes that were paid in the first year.

To provide such recognition, the company's minimum tax liability should be calculated on a cumulative basis. In this way, taxes paid in excess of the minimum for prior years could count against the minimum tax for the current year.

4. The Minimum Base Should Be Reduced So That in Most Cases Companies Would Be Taxed on Their Income Rather Than on an Imputed Tax Base That Actually Measures Wealth, Not Income.—Although the proposal seeks to tax companies on their economic income—their gain from operations—it will fail to do so in the case of most mutual companies. Instead of an income tax, these companies will incur an excise tax based on their net worth. What might have worked in theory turns out to need an adjustment in practice.

To avoid this severe difficulty, the minimum tax base should be reduced in order to return most mutual companies to a tax based on income rather than one based on wealth. The adjustment would also further competitive equity. Without the adjustment, mutuals are isolated, with a tax base unlike that applicable to their competitors. By putting most mutuals on the same tax base as the stocks, the adjustment would greatly reduce the likelihood that tax provisions will inadvertently distort marketplace competition.

Finally, I would note that under our suggested amendments to the proposal, stock companies as well as mutuals would be subject to the minimum tax base. We, of course, have in mind that their minimum base, like ours, would be subject to the reduction suggested here.

II. A flat dividend disallowance would remove many of the difficulties that are inherent in a tax based on the surplus/interest approach

As I stated at the outset, many mutual companies cannot accept a surplus-based tax approach. They believe that fair competition will be impossible if their competitors are taxed on income but they are taxed on net worth. Most, if not all, mutuals feel that it would be preferable to recognize ownership by a specific limitation on dividend deductibility.

A net worth tax would encourage mutual companies to reduce the protection for consumers that is provided by surplus. By helping to ensure solvency, company surplus is an essential source of protection for policyholders. Because of the fundamental importance of protecting consumers, both the regulation and the taxation of insurance companies should encourage company conduct that increases such security. At the very least, tax rules should do nothing to encourage companies to decrease their policyholders' safety. Yet that is exactly what an earnings-on-surplus tax does. It drives companies toward reducing their surplus in order to reduce their taxes.

If there is to be a stock/mutual tax differential, its structure should be guided by considerations of equitable competition and policyholder security. Accordingly, we urge that any differential should be a partial disallowance of the deduction for dividends and not a tax based on surplus. Stock companies would have all the tax advantage that they need if the mutuals were barred from deducting 7½ percent of dividends paid. In any event, the disallowance should be no greater than 10 percent.

A comparison with the operation of stock companies establishes the lower of these figures as the correct one. For the purposes of the comparison, it is possible to assume that mutuals receive capital from, and distribute corporate earnings to, their policyholders at the same rate that the stocks do. Stock companies cannot deduct distributions to their shareholders of earnings and profits, nor are they required to include in income any paid-in capital that they receive from their shareholders. Using operating data from 1977 to 1981, the comparison demonstrates that the correct level of disallowance is between 5.8 percent and 7.5 percent.

Those companies that cannot accept a net worth tax believe that all mutual companies would find it possible to work within a dividend deduction disallowance of 10 percent. Furthermore, those companies are prepared to agree that mutual companies should in any event be subject to an appropriate minimum tax on gain from operations before dividends. This would preclude the possibility that any mutual company would "dividend out" of its tax liability.

OTHER COMPANY-TAX ISSUES

I. The 25 percent taxable income adjustment should be eliminated and replaced by a correction of the flaws in the initial computation of taxable income

The proposal contains a suggestion for a 25 percent reduction in otherwise taxable income. This reduction is called the "taxable income adjustment." It creates the appearance that, after the proposal had been put together, detail by detail, someone stepped back, saw that the tax liability produced was too high, and concluded "The result is wrong. Something isn't working. Let's change the result." Such a patch, however, treats the symptom, not the disease.

If the overall proposal produces too high a tax liability because it taxes more than economic income, the proper solution is to correct those flawed aspects of the proposal that lead to this result. In the case of the mutuals, the result flows from the method of determining the ownership differential. There may be other flaws affecting the liability of stock companies.

II. The stock subsidiary of a mutual company should be taxed like a stock company

The Stark/Moore proposal suggests applying the ownership differential not only to mutual life insurance companies but to stock life insurance subsidiaries of mutual life companies.

The justification for applying an ownership differential to a mutual company was that the company's customers are also its owners. This very justification, however, should preclude applying the differential to a stock subsidiary of a mutual company. The role of the policyholders of a subsidiary of a mutual company does not differ in any way from the role of the policyholders of any other stock life insurance company. They are not its owners; they have no "investment in the company." It follows that the stock subsidiary of a mutual company should be taxed as a stock company.

If receipt of policyholder dividends (broadly conceived) creates a deemed ownership interest for tax purposes, then some ownership differential should apply to all stock companies that distribute such dividends. If receipt of such dividends does not create an ownership interest, then there is no way in which the policyholders of the subsidiary are its owners. Since they are not owners, there is no baisis on which to apply any ownership differential to the subsidiary.

Furthermore, the principle of taxing income only once at the corporate level should be reflected in the way the ownership differential provision determines the equity of a mutual company that has a subsidiary: The value of the stock of the subsidiary must be removed from the equity of the mutual parent. To tax simultaneously both the earnings of the subsidiary and the equity that underlies these earnings is to impose a second corporate-level tax on what is essentially the same income. All other corporations pay only a single corporate level tax on the income of a subsidiary, and the same should be true of mutual life insurance companies.

III. Reserves for tax purposes should not be determined by reference to State law minimums

Mutual companies support the use of CRVM reserves with a cash value floor in the case of individual cash value life insurance. We believe that this standard accurately reflects a company's contractual liabilities to its policyholders. The required use of state minimum valuation bases in the case of individual cash value life insurance as well as in the case of other insurance products is not appropriate because state law may appear to permit companies to assume rates of long-term assumed return that are higher than many actuaries would accept as being sound. Such state law is in fact relying on mechanisms other than statutory minimum valuation bases to assure that reserves accurately estimate the company's future liabilities.

For instance, a recent change in the laws of some states not only grants companies additional flexibility in the interest rate to be assumed in calculating reserves but also adds a new requirement that such reserves be actuarially certified as sufficient. In essence, the new maximum interest rates can be too high to be acceptable without an accompanying expert judgment as to the appropriateness of their use for the particular reserves in question.

It would, therefore, be wrong to tie deductibility for tax purposes to the most liberal valuation standards that the state will allow to be so certified. Uncertified reserves using such standards are unacceptable to the state, presumably because they are less than a correct estimate of the company's future liability.

Tax law should avoid the use without certification valuation standards which have become acceptable under state law only when accompanied by individualized actuarial certification. In the absence of such certification, tax law should use a more certain estimate of the company's future liability. The Commissioners Reserve Valuation Method and the valuation bases filed with the state by the company are generally regarded as an accurate method of assessing future liability, one that is neither too conservative nor too liberal.

IV. The transition rules for levels of reserves should take past tax benefits into account

The proposal suggests that any reduction in tax reserves attributable to the new law should be taken into income over a ten year period. This provision implicitly assumes that all companies enjoyed a tax deduction when the prior level of tax reserves was put up.

In the case of mutual companies, however, that is generally not the case. Under the 1959 Act, these companies were taxed on their investment income, not on their gain from operations. They thus received no tax benefit from a deduction for increases in reserves and only a minimal tax benefit from the interaction between the level of reserves and the measurement of investment income.

To attribute ten years of income to both stocks and mutuals as if both had enjoyed full reserve deductions under the 1959 Act would be as unfair as it is unrealistic. A fair transition rule would attribute income from the transitional reserve reduction only to the extent that the taxpayer had enjoyed a tax benefit from the earlier reserve increase.

POLICYHOLDER ISSUES

The proposal also addresses three areas affecting the taxation of policyholders on which I would like to comment briefly.

I. The proposed definition of life insurance is fair and reasonable

First, tax treatment as life insurance should not be available to investment contracts with only a thin veneer of insurance. The proposed definition of life insurance achieves this end by assuring that, in order to qualify as life insurance, a contract must maintain a reasonable amount of risk at all times. Both "Alternative 1" and "Alternative 2" apply meaningful tests which are of comparable stringency. Adopting the definition will therefore create a level playing field both for those policies which would qualify as life insurance contracts and for those investment contracts which would not.

The proposed definition should, however, be modified in one technical respect in order to assure fair competition among *all* life insurance products. As drafted, the proposal treats excess interest accumulations much more favorably than it does dividend accumulations. As the two types of accumulations are economically equivalent, competitive equity and economic neutrality require an amendment to extend the favorable tax treatment to dividend accumulations, so long as the underlying contract (including the tax-favored portion of the accumulation fund) meets the proposed definition of life insurance.

II. Computation of investment in life insurance contracts

Second, under existing law, a policyholder of a permanent life insurance contract is taxed on amounts actually received prior to death to the extent that the amounts received exceed the policyholder's investment in the contract. "Investment in the contract" (or basis) is calculated by adding all of the premiums paid by the policyholder and subtracting from that sum all amounts previously received that were nontaxable.

The proposal would amend the definition of "investment in the contract" to require that the pure term insurance costs be subtracted from premiums paid, a subtraction which would be in addition to that required under current law. The effect of this proposal would subject life insurance, a personal asset, to unique treatment.

In the case of all other personal assets, no basis reduction is required for depreciation that would have been allowable if the asset had been a business asset. Nor is the taxpayer's basis reduced by the value of any personal benefit derived from the use of an asset. Unless and until the rules change for other personal assets, life insurance should not be singled out for discriminatory treatment.

In addition, the proposal would affect most adversely older persons, as their term insurance costs are highest and hence their basis adjustments would be the greatest. Facing higher taxes on the exercise of their retirement options under their policies, these older insureds may lose much of their incentive to keep their policies in force.

III. Policyholder loans

Third, the proposal to deny interest deductibility on policy loans in excess of $50,000, is in our opinion, both unfair and impractical. It will not raise a significant amount of taxes but will create many problems.

Denial of interest deductions on policy loans would be perceived as a serious tax disadvantage to prospective insurance purchasers, and these purchasers will find little solace in the $50,000 "safe harbor."

Moreover, this change in tax policy would affect only one form of appreciating asset—individual life insurance. Interest paid on loans secured by appreciated assets other than insurance would continue to be tax deductible. There is no sound reason for treating cash value life insurance any differently.

Existing law already contains meaningful limitations on the deductibility of policy loan interest. Generally, interest on policy loans and other indebtedness incurred to purchase cash value life insurance is not deductible unless the policyholder pays at least four of the first seven premiums in cash and not with borrowed funds. These limitations, together with an improved definition of life insurance, would provide adequate safeguards against abuse.

The effect of this proposal on existing policyholders is most unfair. They have purchased long term insurance protection under the reasonable assumption that they would receive the same tax treatment when borrowing against their policies' cash surrender values as they would when borrowing against any of their other appreciated assets. Any such changes should be made applicable to new policies only.

Chairman **Stark**. Now we will hear from Mr. Beck.

STATEMENT OF ROBERT A. BECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE PRUDENTIAL INSURANCE CO. OF AMERICA

Mr. **Beck**. Thank you very much, Mr. Chairman and members of the subcommittee.

My name is Bob Beck, chairman and chief executive officer of The Prudential Insurance Co. of America. I, too, appreciate the subcommittee's invitation to testify on the discussion proposal developed by the chairman and Representative Moore.

The proposal reflects an extraordinary and thoughtful effort by the subcommittee and the staff. The overall structure of the proposal provides the basis for a fairer, simpler, and more rational tax law for our industry. As currently drafted, however, the proposal places an excessive tax burden on the industry in general, and on the mutuals in particular.

We would emphasize, however, that what is wrong with the proposal, we believe, can be fixed and the process of developing a new tax law for life insurance companies must continue full speed ahead.

As you requested, I will discuss the direct impact of the Stark-Moore proposal on mutual life insurance companies. Bob Van Fossan provided an overview of mutual company views on specific elements of the proposal, including the ownership differential. My purpose today is to focus in detail on the critical ownership differential issue.

However, before addressing this issue, I have several comments on the aggregate industry tax burdens that this proposal would produce and why the total life insurance industry tax burden would be excessive.

We are an industry in transition. Just last week, I testified before a subcommittee of the House Commerce Committee on far-reaching proposals to deregulate the financial services industry. The thrust toward deregulation of the financial services industry, high interest rates and inflation, and extraordinary advances of technology are placing tremendous competitive pressures on the life insurance industry to increase productivity, reduce expenses, and cut margins.

We face a future of competing head-to-head for the savings dollars of Americans not merely with other life insurers but with all financial intermediaries.

This month, we at Prudential undertook a major reorganization and consolidation that resulted in eliminating 4,000 Prudential jobs. We deeply regretted the effects of this decision on many loyal Prudential employees, and have tried to do everything in our power to soften the impact. However, we had no other choice but to take this drastic action if we are to meet the challenges of the marketplace.

In considering the appropriate aggregate industry tax burden, I urge that the subcommittee be sensitive to the wrenching transition the life insurance industry is experiencing in the way we do business. The tax burden you place on us will directly affect the competitive equilibrium of the marketplace.

We, like Ian Rolland, believe any aggregate industry tax burden in excess of $2.5 billion would place us at a serious competitive disadvantage. And there is good documentation of hard facts to demonstrate the validity of this information.

As the savings and loan industry knows all too well, unless all financial intermediaries compete on a level playing field, the institution shackled with too many restrictions or too high a tax burden can find itself in a life-threatening situation.

Now, if I may, I would like to comment on the return on equity concept.

The Stark-Moore proposal introduces a new concept that offers great promise for unraveling a mystery that has baffled tax policymakers since the inception of the Federal income tax law: How to determine the income tax base for the life insurance industry in general and for mutual life insurance companies in particular.

Stated broadly, the concept is that the corporate income of mutual companies is their return on invested capital or equity. It is assumed that this income can be approximated by determining the equity of a mutual company and by imputing a return on this equity.

It is also assumed that mutual life company returns are similar to returns on equity earned by stock life insurance companies and, perhaps, by corporations in general.

While we have serious reservations about the mechanical application of this concept—particularly in its current form—we believe that the concept provides the most helpful method, developed to date, for comparing relative Federal income tax burdens.

Since corporations generate income by investing their equity, and since risk-adjusted returns in the marketplace seek equilibrium over periods of time, it seems reasonable to measure relative income tax burdens by comparing taxes to equity within the industry and with other businesses.

First, I would like to use this equity concept to compare the tax burden of our industry to the tax burden of corporations generally. We believe that this comparison demonstrates that the aggregate revenue level of the Stark-Moore proposal on our industry is clearly excessive and that revenues of the magnitude projected for stopgap are closer to the mark.

Consider the following comparisons we have made. In our first chart, we compared taxes as a percentage of equity for the life insurance industry, for other financial intermediaries, and for all corporations. As can be seen, if Stark-Moore had been in effect in 1982, the life insurance industry in the aggregate would have paid taxes equal to 6 percent of equity, while other financial intermediaries paid only about 1.1 percent and the burden for corporations in general was only about 2.1 percent.

It is noteworthy that the tax burden imposed on the life insurance industry under stopgap as a percentage of equity was 2.5 percent, which exceeds the percentage for other financial institutions and corporations in general.

We then looked at what the impact of the proposal would be on Prudential as compared with several other major financial institutions. The results of this comparison are illustrated in the second chart.

For 1982, Prudential would have paid taxes under the proposal equal to 7.3 percent of equity and, in fact, paid taxes under stopgap equal to 3.1 percent of equity.

By contrast, the tax to equity percentage for Citicorp was .09 percent, for Sears was .9 percent, and for American Express was 2.8 percent.

Applying the proposal's tax to equity concepts, these comparisons, we believe, indicate dramatically the excessive aggregate tax burden that would be imposed on our industry.

Let me turn now to the proposal's specific ownership differential mechanism under which policyholder dividends would be limited by a tax base equal to an imputed return on equity.

Let there be no misunderstanding. Most mutual companies believe that an ownership differential is neither justified nor necessary under a single phase tax law based on economic income. Notwithstanding these deep-felt objections, we recognize the need to accept some form of reasonable ownership differential to achieve a permanent tax law.

Reaching this consensus on the imposition of an ownership differential has been very difficult for us, and, as Bob Van Fossan has indicated, we continue to struggle to reach a consensus on a single approach. However, the mutual industry is united in its belief that the mutual form of doing business should not lose its viability because of an unfair tax burden.

There is no question that an ownership differential of anything approaching the magnitude of the differential in the proposal is excessive and insupportable. Indeed, it is punitive.

To give some specific facts, we estimate that, in the aggregate, the proposal would result in the equivalent of a disallowance of over 60 percent of policyholder dividends in 1984, an amount in excess of those disallowed under the 1959 act or under even the most aggressive stock company analysis.

For several mutual companies, both large and small, 100 percent of policyholder dividends would be disallowed under the proposal.

Since the proposed differential is based on imputed equity returns, let's examine how the mutual company share of industry taxes compares with the mutual company share of equity.

Chart 3 demonstrates the facts. In 1984, mutual companies would be paying taxes equal to 7.6 percent of equity while stock company taxes as a percentage of equity would only be 4.2 percent.

Other witnesses will discuss in detail how the tax adversely impacts on their companies and the competitiveness of specific product lines. However, in this next chart, chart 4, we summarize a simple example that illustrates how a differential of the magnitude that has been proposed will make mutual companies noncompetitive.

Although the chart only illustrates the effect of the differential on variable life insurance, a differential of this magnitude would make almost all of our product lines similarly noncompetitive.

Consistent with the aggregate effects of the ownership differential proposal, we assume that 64 percent of amounts credited in excess of the assumed crediting rate would be disallowed.

If the policyholders' funds earn 12 percent, the stock company could credit 11.25 percent, while the mutual could credit only 9.45 percent because of the additional tax imposed. These differences in crediting rates dramatically affect the growth of the death benefits provided. At a 12-percent earnings rate, the death benefit provided by the mutual is only 63 percent of the comparable stock company death benefit.

I should point out that even if the dividend disallowance percentage in the example were reduced to 24 percent, the percentage that staff believed the proposal would produce, mutuals would still be noncompetitive. This is because at a dividend disallowance of 24 percent, mutuals would be forced to credit 75 basis points less than their stock competitors.

The proposal's specific problems: Why has the proposal created such disparities in mutual company tax shares and product taxation? While we discuss the technical details of the proposal in a written submission filed with the committee today, let me summarize six major problem areas.

First, the proposal does not create a one-phase tax system. Instead, stock companies are taxed on their economic income, while mutual companies are taxed on an imputed return on equity. Because the proposal uses inflated equity and rate of return figures, mutual companies rarely, if ever, will pay tax on their economic income.

Second, the three-factor rate of return formula is flawed because two of the factors have no relationship at all to rates of return for life insurance companies. In particular, T-bill rates and industrial corporate rates of return are irrelevant and should be eliminated.

Third, the proposed adjustments made to statutory surplus significantly overstate the equity base.

Fourth, the base is not adjusted to recognize tax preference items, such as tax-exempt interest, capital gains, and accelerated depreciation. These tax preference items are available to all other corporations, including stock life insurance companies, and must be recognized through adjustments to the minimum tax base.

Fifth, the imputed equity return formula is based on averages and not on the circumstances of particular companies. An arbitrary earnings formula does not recognize year-to-year variations in earnings, operation losses, or simply that some companies will not meet average earnings expectations.

When used as a minimum tax base, an imputed equity return formula will result in substantial overtaxation unless adjustments are made to reflect particular company circumstances. However, even with these adjustments, an imputed return formula can only provide a reasonable measure of parity if it is applied to all segments of the industry, both mutual and stock companies.

Finally, all mutual companies are concerned about the nontax-related implications of a tax based on earnings on surplus. A tax law that puts undue pressure on companies to reduce their surplus for tax reasons is not in the best interest of life insurance consumers.

Despite these serious problems, we are firmly convinced that we can achieve a reasonable solution to the ownership differential issue. We believe that the Stark-Moore equity return framework provides a measure for testing whether the solution is a reasonable one.

Under one approach, the Stark-Moore framework would be adjusted to reflect the specific problems outlined previously with its technical application. We would also propose allowing companies to deduct a minimum percentage of policyholder dividends. In the context of an imputed equity return minimum tax base, no less than a specified level of dividends would be deductible.

It is also absolutely essential for competitive neutrality that the formula apply to both mutual and stock companies. The theory of the minimum tax base is that it provides a good approximation of what the earnings of a mutual company would be if it were a stock company.

If it is a good approximation of stock company earnings, stock companies should have no objection to the minimum tax applying to them. To the extent the approximation is inaccurate—in general or for any particular company—the burden should be borne equally by mutual and stock companies so we have a level playing field for the life insurance industry.

Another approach has been described in Bob Van Fossan's testimony and will be covered in detail in the testimony of John Creedon.

I must also comment briefly on the proposal's discriminatory treatment of stock life insurance subsidiaries of mutual companies. This issue will be less significant if the appropriate minimum tax is applied to both mutual and stock life insurance companies.

However, if any differential applies soley to mutual companies, there is no justification for applying it to our stock subsidiaries.

The crux of the ownership differential argument is that you should treat mutual companies differently because their policyholders are both owners and customers. However, this reasoning does not apply to our subsidiaries.

Like all stock companies, our subsidiaries have a separate class of shareholders, which include the mutual parent. Like all stock companies, our subsidiaries are operated to earn a profit for their shareholders. You should not discriminate against one class of stock life insurance company simply because they are owned by mutual life insurance companies.

I know some allege that despite duties to our own policyholders and state law regulation, we will somehow operate our subsidiaries like mutual companies in the future. While this allegation is unfounded, you can protect against possibilities of abuse in the usual way of giving the Secretary of Treasury the power to act in appropriate cases.

However, an overly broad rule discriminating against our stock life insurance subsidiaries should not be adopted.

Mr. Chairman, I have focused my comments on the critical ownership differential issue. I want to add my full support for the views expressed by my colleague Bob Van Fossan on the policyholder provisions of the bill.

In particular, the proposals on policy loans and investment in life insurance policies would discriminate against the life insurance consumer and should not be adopted.

Let me emphasize again in closing, Mr. Chairman, that mutual companies believe that the Stark-Moore framework has moved the industry a long way toward a more rational tax law. On the other hand, our analysis indicates that there are serious problems with the proposal's ownership differential. Nevertheless, we believe that these problems can be solved.

Thank you, Mr. Chairman, for listening to our views. We will be happy to answer any questions.

Chairman **Stark**. Thank you, gentlemen.

[The prepared statement follows:]

STATEMENT OF ROBERT A. BECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE PRUDENTIAL INSURANCE CO. OF AMERICA

Mr. Chairman and Members of the Subcommittee, I am Robert Beck, Chairman and Chief Executive Officer of The Prudential Insurance Company of America. I appreciate the Subcommittee's invitation to testify on the discussion proposal developed by the Chairman and Representative Moore. The proposal reflects an extraordinary and thoughtful effort by the Subcommittee and the staff. It is an important step in the direction of a fairer, simpler and more rational tax law for our industry. As currently drafted, however, the proposal does not meet its goal of creating a single phase tax for all life insurance companies. In addition, it places an excessive tax burden on the industry in general, and on the mutuals in particular. We would emphasize, however, that what is wrong with the proposal can be fixed and the process of developing a new tax law for life insurance companies must continue full speed ahead.

As you requested, I will discuss the direct impact of the Stark-Moore proposal on mutual life insurance companies. Bob Van Fossan provided an overview of mutual company views on specific elements of the proposal, including the ownership differential. My testimony will focus in detail on the critical ownership differential issue. However, before addressing this issue, I have several comments on the aggregate industry tax burdens that this proposal would produce and why the total life insurance industry tax burden would be excessive.

I. AGGREGATE INDUSTRY TAX BURDENS

A. An industry in transition

Just last week, I testified before a Subcommittee of the House Commerce Committee on far reaching proposals to deregulate the financial services industry. The thrust toward deregulation of the financial services industry, high interest rates and inflation, and extraordinary advances of technology are placing tremendous competitive pressures on the life insurance industry to increase productivity, reduce expenses and cut margins. We face a future of competing head-to-head for the savings dollars of Americans not merely with other life insurers but with all financial intermediaries. This month, we at Prudential undertook a major reorganization and consolidation that resulted in eliminating 4000 Prudential jobs. We deeply regretted the effects of this decision on loyal Prudential employees and have tried to do everything in our power to soften the impact. However, we had no other choice but to take this drastic action if we are to meet the challenges of the marketplace. In considering the appropriate aggregate industry tax burden, I urge that the Subcommittee be sensitive to the wrenching transition the life insurance industry is experiencing in the way we do business. The tax burden you place on us will directly affect the competitive equilibrium of the marketplace. We believe any aggregate industry tax burden in excess of $2.5 billion would place us at a serious competitive disadvantage. As the Savings and Loan industry knows all too well, unless all financial intermediaries compete on a level playing field, the institution shackled with too many restrictions or too high a tax burden can find itself in a life threatening situation.

B. The return on equity concept

The Stark-Moore proposal introduces a new concept that offers great promise for unraveling a mystery that has baffled tax policy makers since the inception of the federal income tax law—how to determine the income tax base for the life insurance industry in general and for mutual life insurance companies in particular. Stated broadly, the concept is that the corporate income of mutual companies is their return on invested capital or equity. It is assumed that this income can be approximated by determining the equity of a mutual company and by imputing a return on this equity. It is also assumed that mutual company returns are similar to returns on equity earned by stock life insurance companies and, perhaps, by corporations in general.

While we have serious reservations about the mechanical application of this concept—particularly in its current form—we believe that the concept provides the most helpful method, developed to date, for comparing relative federal income tax burdens. Since corporations generate income by investing their equity, and since risk-adjusted returns in the marketplace seek equilibirum over periods of time, it seems reasonable to measure relative income tax burdens by comparing taxes to equity within the industry and with other businesses.

1. Industry Tax to Equity Comparisons.—First, I would like to use this equity concept to compare the tax burden of our industry to the tax burden of corporations generally. We believe that this comparison demonstrates that the aggregate revenue level of the Stark-Moore proposal on our industry is clearly excessive and that revenues of the magnitude projected for Stopgap are closer to the mark.

Consider the following comparisons we have made. In our first chart, we compared taxes as a percentage of equity for the life insurance industry, for other financial intermediaries, and for all corporations.[1] As can be seen, if Stark-Moore had been in effect in 1982, the life insurance industry in the aggregate would have paid taxes equal to 6 percent of equity, while other financial intermediaries paid only about 1.1 percent and the burden for corporations in general was only about 2.1 percent. It is noteworthy that the tax burden imposed on the life insurance industry under Stopgap as a percentage of equity was 2.5 percent, which exceeds the percentage for other financial institutions and corporations in general.

2. Company Tax to Equity Comparisons.—We then looked at what the impact of the proposal would be on Prudential as compared with several other major financial institutions. The results of this comparison are illustrated in the second chart.

For 1982, Prudential would have paid taxes under the proposal equal to 7.3 percent of equity and, in fact, paid taxes under Stopgap equal to 3.1 percent of equity.

By contrast, the tax to equity percentage for Citicorp was .09 percent, for Sears was .9 percent, and for American Express was 2.8 percent.

Applying the proposal's tax to equity concepts, these comparisons indicate dramatically the excessive aggregate tax burden that would be imposed on our industry.

II. THE OWNERSHIP DIFFERENTIAL

Let me turn now to the proposal's specific ownership differential mechanism under which policyholder dividends would be limited by a tax base equal to an imputed return on equity.

Let there be no misunderstanding. Most mutual companies believe that an ownership differential is neither justified nor necessary under a single phase tax law based on economic income. Notwithstanding these deep-felt objections, we recognize the need to accept some form of reasonable ownership differential to achieve a permanent tax law. Reaching this consensus on the imposition of an ownership differential has been very difficult for us, and, as Bob Van Fossan has indicated, we continue to struggle to reach a consensus on a single approach. However, the mutual industry is united in its belief that the mutual form of doing business should not lose its viability because of an unfair tax burden.

There is no question that an ownership differential of anything approaching the magnitude of the differential in the proposal is excessive and insupportable. Indeed, it is punitive. To give some specific facts, we estimate that, in the aggregate, the proposal would result in the equivalent of a disallowance of over 60 percent of policyholder dividends in 1984, an amount in excess of those disallowed under the 1959 Act or under even the most aggressive stock company analysis. For several large mutual companies, 100 percent of policyholder dividends would be disallowed under the proposal.

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[1] For life insurance companies, we based our comparisons on 1982 Stopgap tax revenues and on revenues that would have been produced under the Stark-Moore proposal. For this purpose, we computed equity under the rules currently in the proposal. The percentage for all corporations is based on 1982 Budget data. The percentage derived for other financial institutions is taken from Treasury Statistics of Income data for 1980. Figures for 1981 and 1982 are unavailable.

A. Mutual-stock tax to equity disparities

Since the proposed differential is based on imputed equity returns, let's examine how the mutual company share of industry taxes compares with the mutual company share of equity. We have made this comparison in the third chart attached to the testimony. As estimated by the ACLI, the mutual company share of taxes in 1984 under the proposal would be 63 percent. On the other hand, under the proposal, the mutual company share of industry equity is 49 percent. Thus, mutuals who have less than half the industry's equity would pay two-thirds of the industry's taxes. The results following from this disparity between taxes and equity are illustrated on chart 4. In 1984, mutual companies would be paying taxes equal to 7.6 percent of equity, while stock company taxes as a percentage of equity would only be 4.2 percent. As illustrated by chart 5, this tax to equity disparity is even more pronounced when small mutual and stock companies are compared. If equity is a reasonable base for computing taxable earnings, these results are clearly inappropriate.

B. Product disparities

Other witnesses will discuss in detail how the tax to equity disparity adversely impacts on their companies and on the competitiveness of specific product lines. However, in chart 6, we summarize a simple example that illustrates how a differential of the magnitude that has been proposed will make mutual companies noncompetitive. Although, the chart only illustrates the effect of the differential on variable life insurance, a differential of this magnitude would make almost all our product lines similarly noncompetitive. Consistent with the aggregate effects of the ownership differential proposal, we assume that 64 percent of amounts credited in excess of the assumed crediting rate would be disallowed. If the policyholders' funds earn 12 percent, the stock company could credit 11.25 percent, while the mutual could credit only 9.45 percent because of the additional tax imposed. These differences in crediting rates dramatically affect the growth of the death benefits provided. At a 12 percent earnings rate, the death benefit provided by the mutual is only 63 percent of the comparable stock company death benefit.

I should point out that even if the dividend disallowance percentage in the example were reduced to 24 percent, the percentage that the staff believed the proposal would produce, mutuals would still be noncompetitive. This is because at a dividend disallowance of 24 percent, mutuals would be forced to credit 75 basis points less than their stock competitors.

C. The proposals' specific problems

Why has the proposal created such disparities in mutual company tax shares and product taxation? While we discuss the technical details of the proposal in a written submission filed with the Committee today, let me summarize six major problem areas.

First, as I stated in my opening remarks, the proposal does not create a one-phase tax system. Instead, stock companies are taxed on their economic income, while mutual companies are taxed on an imputed return on equity. Because the proposal uses inflated equity and rate of return figures, mutual companies rarely, if ever, will pay tax on their economic income.

Second, the three-factor rate of return formula is flawed because two of the factors have no relationship at all to rates of return for life insurance companies. In particular, T-bill rates and industrial corporate rates of return are irrelevant and should be eliminated.

Third, the proposed adjustments made to statutory surplus significantly overstate the equity base.

Fourth, the base is not adjusted to recognize tax preference items, such as tax-exempt interest, capital gains, and accelerated depreciation. These tax preference items are available to all other cooperations, including stock like insurance companies, and must be recognized through adjustments to the minimum tax base.

Fifth, the imputed equity return formula is based on averages and not on the circumstances of particular companies. An arbitrary earnings formula does not recognize year to year variations in earnings, operation losses or simply that some companies will not meet average earnings expectations. When used as a minimum tax base, an imputed equity return formula will result in substantial overtaxation unless adjustments are made to reflect particular company circumstances. However, even with these adjustments, an imputed return formula can only provide a reasonable measure of parity if it is applied to all segments of the industry, both mutual and stock companies.

Finally, all mutual companies are concerned about the nontax related implications of a taxed based on earnings on surplus. A tax law that puts undue pressure on companies to reduce their surplus for tax reasons is not in the best interest of life insurance consumers.

D. Proposed solutions

Despite these serious problems, we are firmly convinced that we can achieve a reasonable solution to the ownership differential issue. We believe that the Stark-Moore equity return framework provides a measure for testing whether the solution is a reasonable one. We urge consideration of two possible approaches.

Under the first approach, the Stark-Moore framework would be adjusted to reflect the specific problems outlined previously with its technical application. We would also propose allowing companies to deduct a minimum percentage of policyholder dividends. In the context of an imputed equity return minimum tax base, no less than a specified level of dividends would be deductible.

It is also absolutely essential for competitive neutrality that the formula apply to both mutual and stock companies. The theory of the minimum tax base is that it provides a good approximation of what the earnings of a mutual company would be if it were a stock company. If it is a good approximation of stock company earnings, stock companies should have no objection to the minimum tax applying to them. To the extent the approximation is inaccurate (in general or for any particular company), the burden should be borne equally by mutual and stock companies so we have a level playing field for the life insurance industry.

Another approach favored by several mutual companies is that we change the proposal in favor of (1) a direct limitation on the deduction of policyholder dividends and (2) a minimum tax related to gain from operations before policyholder dividends. For example, the law could provide a direct disallowance of 5 to 10 percent of policyholder dividends and a minimum tax base equal to 10 percent of gain from operations before policyholder dividends.

E. Discriminatory treatment of stock life insurance subsidiaries

Let me also comment briefly on the proposal's discriminatory treatment of stock life insurance subsidiaries of mutual companies. This issue will disappear if the appropriate minimum tax is applied to both mutual and stock life insurance companies. However, if any differential applies solely to mutual companies, there is no justification for applying it to our stock subsidiaries.

The crux of the ownership differential argument is that you should treat mutual companies differently because their policyholders are both owners and customers. However, this reasoning does not apply to our subsidiaries. Like all stock companies, our subsidiaries have a separate class of shareholders, which include the mutual parent. Like all stock companies, our subsidiaries are operated to earn a profit for their shareholders. You should not discriminate against one class of stock life insurance company simply because they are owned by mutual life insurance companies.

I know some allege that despite duties to our own policyholders and state law regulation, we will somehow operate our subsidiaries like mutual companies in the future. While this allegation is unfounded, you can protect against possibilities of abuse in the usual way of giving the Secretary of Treasury the power to act in appropriate cases. However, an overly broad rule discriminating against our stock life insurance subsidiaries should not be adopted.

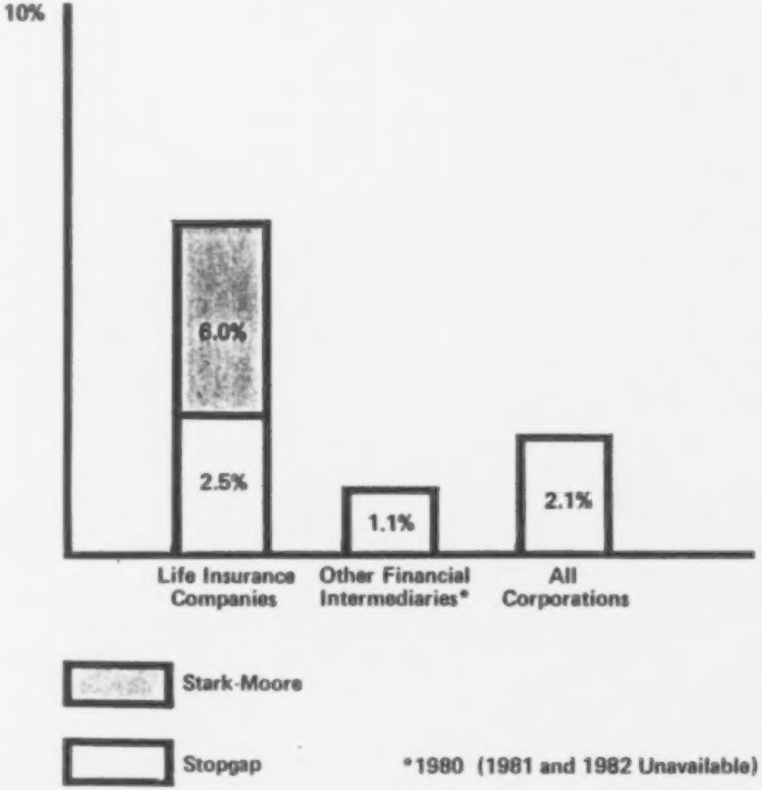
One last point, if we strike the right balance between stocks and mutuals, then the whole issue of stock subsidiaries of mutual becomes academic. This is because there would be no tax incentive for mutuals to issue products in their subsidiaries.

III. CONCLUSION

Let me emphasize again in closing, Mr. Chairman, that mutual companies believe that the Stark-Moore framework has moved the industry a long way toward a more rationale tax law. On the other hand, our analysis indicates that there are serious problems with the proposal's ownership differential. Nevertheless, we believe that these problems can be solved.

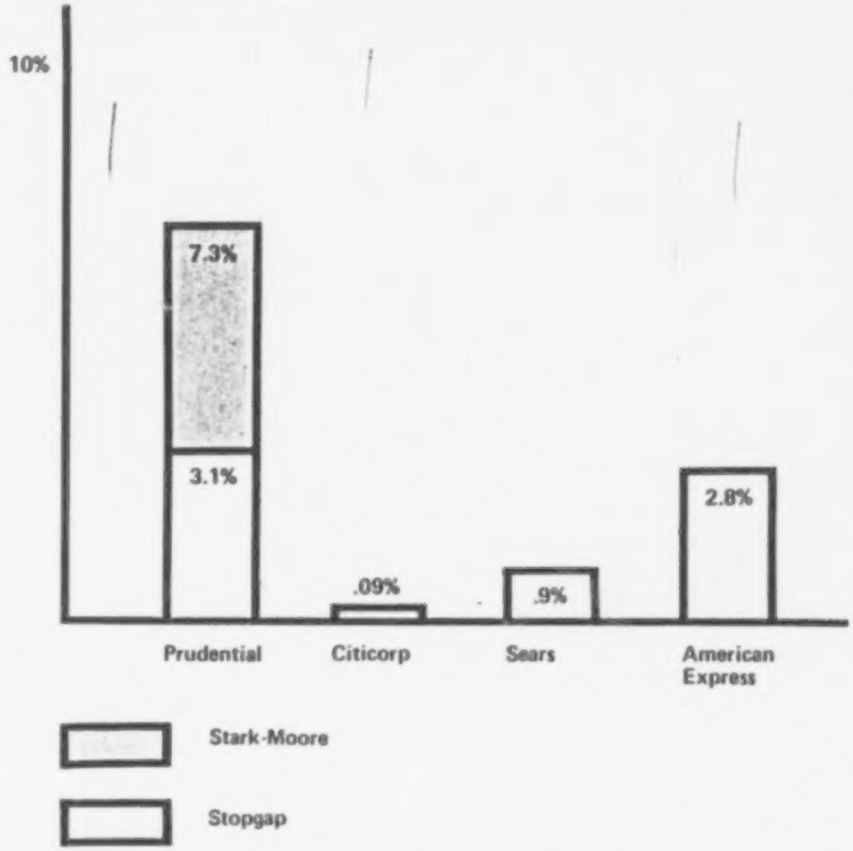
Thank you, Mr. Chairman, for listening to our views. We will be happy to answer any questions.

1. Taxes as Percentage of Equity -- Industries - 1982

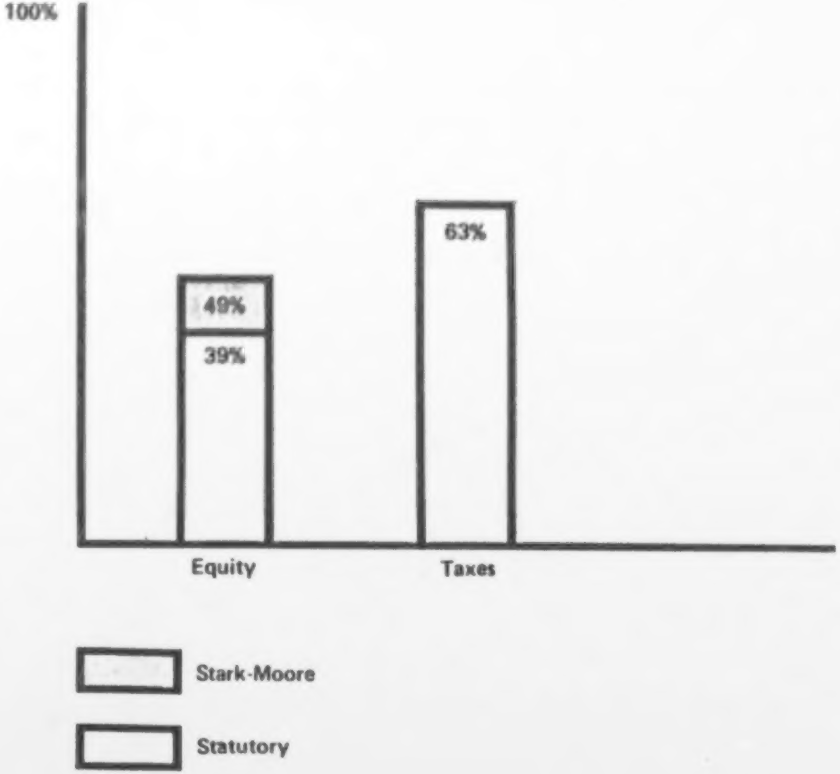


*1980 (1981 and 1982 Unavailable)

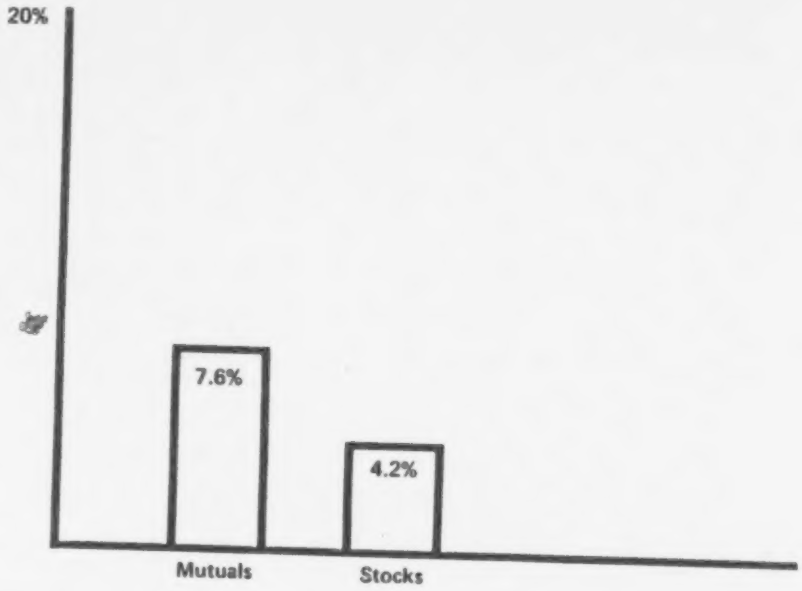
2. Taxes as Percentage of Equity -- Companies - 1982



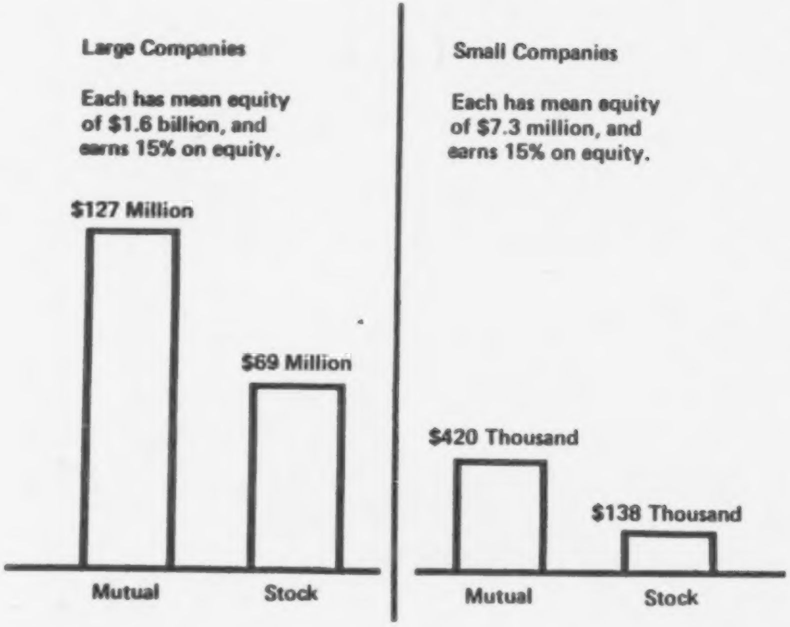
3. Mutual Companies Share of Taxes and Equity Under Proposal - 1984



4. Mutual and Stock Taxes as
Percent of Equity Under Proposal - 1984



5. Comparitive Tax Burdens Under Stark-Moore



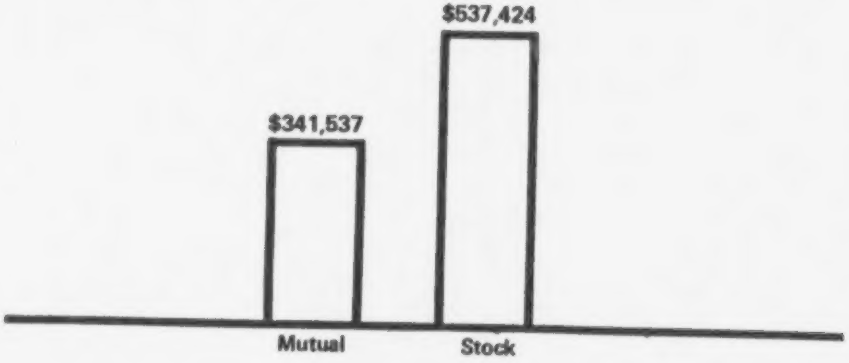
6. Product Comparison -- Stock V. Mutual

Example Based Upon a 35 Year Old Male Purchasing $100,000
Variable Life Insurance Policy

Dividend Disallowance	
Stock	0
Mutual	64%

Crediting Rate to Policyholder at 12% Earnings Rate	
Stock	11.25
Mutual	9.45

Death Benefit*



*At life expectancy.

Chairman STARK. I just have a couple of comments.

I appreciate your interest in the framework, but as I review your testimony, I find that, out of the 20 proposals in the framework, you only endorse one—the definition. I don't need a lot more help like that.

There are a couple of things that I think I can't individually let stand, and I think that I have got some support out of the industry.

On page 12 of Bob Van Fossan's testimony, there is a statement that is a little bit out of context but it does not change its meaning: "The taxation of insurance companies should encourage company conduct that increases security of the policyholders."

I believe that is absolutely correct. This committee is not charged with the security of policyholders. It is an interesting byproduct if it happens to come up, but we are charged with extracting the proper level of revenue from your industry.

I don't think we want and I don't think you want us to make a distinction as to what is the proper security for your policyholders, because then it would be incumbent on us to set practices in your industry which would guarantee that security.

I submit that, what I am getting to very quickly is that we are not going to take any responsibility for the security of your policyholders unless, in fact, you want us to lay down some conditions under which you operate. I would submit that that is somewhat disingenuous and I don't want to get trapped into not commenting about that. While it would be very nice for the integrity of the assets of your industry to be unimpeachable, recent developments in the State of Ohio show that that is not true.

But it has nothing to do with tax policy. It has to do, if anything, with the incompetent management or imprudent investments, and I don't think you can blame that on the Tax Code. I don't think it can be corrected in the Tax Code. I think that is getting dangerously close to imputing something to the Tax Code that is not there.

As to the flat dividend disallowance, it seems to me that you can't have it both ways. If we are going to tax economic income, then one has to recognize that within a segment of the industry there is going to be different levels of income and to have a flat dividend disallowance is to ignore economic income. I just don't see how those wash. Again, that is an observation.

As to comparing in these charts, which the staff has been showing me here, the compared equity and percentage of taxes again makes economic and commercial practices a reality. Earnings have nothing to do with equity.

It may be a judgment on leverage, which I am sure is something you gentlemen are all very familiar with, but to say that you equate a balance in equity is to say that a balance in equity has to do with earnings. I know that with such outstanding managers as we have before us, they base their excellent results on management ability, not necessarily on pure gross equity. So that I think that we still have to come back to some balance.

I don't like equity. You all seem to like it. I don't know whether I like assets any better.

If I could find an area that you all agree on, I would be surprised. And I think that your testimony, not just because you disagree with most facets of the proposal but because I think 6 months ago it might have been the reverse, show us that the ownership differential is indeed very thorny and is going to end up as a judgment call or a political result. But I hear your objections.

I don't believe that our idea of setting a hypothetical rate of return on a hypothetical equity is any more a tax on surplus than is a deduction on dividends setting a minimum tax. You are all going out the same door you are coming in.

I don't know if the mutual part of the industry has ever paid a tax on operating income in the history of the life insurance business. I don't know what is so unusual about the fact that it won't in the future.

But let me ask this. If the Treasury approach or some other approach were acceptable to the mutual industry in a way as to determine whatever that differential is or a balance between the segments, the industry still is objecting, as I read your testimony, to an adjustor to the rate.

So what you are willing to say is if we vote out a basis for adjusting the balance, that you all want to pay 46 percent of whatever is left. Do you want to stick with that or would you be willing to accept——

Mr. VAN FOSSAN. I don't know that I understand the chairman's inference or his question.

Chairman STARK. There is a tax adjustment factor in our proposal which either indicates that our proposal will raise too much revenue from your industry or it indicates that you have not been paying enough tax in the past.

Mr. BECK. It is 25 percent.

Chairman STARK. And you are suggesting that you don't like it. I am suggesting that you might agree with me that we ought to leave that in there until we see how the numbers come out.

Would that be agreeable with you gentlemen?

Mr. VAN FOSSAN. I think that is a fair statement to make, Mr. Chairman.

Chairman STARK. We are making some progress.

I would like to go through the small company differential approach, whether the exact amounts are not as acceptable to you.

The general definitional approach, without pinning you to numbers, is agreeable?

Mr. VAN FOSSAN. Yes.

Chairman STARK. I guess we come back to having to deal with the segments. Would you care to comment—and that would be my final question—on the overall approach that the Treasury brought up such as using your retained earnings approach, the use of fair market value to measure equity and some of the newer items that Buck brought up this morning?

You may not recall them all but I just wondered, do you want to throw out anything new onto the table? Because I would suggest from what the committee knows and we all know that basically we have considered all these options and none of us have tried to find one.

The only objection I can see is the flat approach does not take into account that there are differences in income. And you are of course saying that because high surplus companies could be booked on our approach, that is unfair because it is not flat. I have no preconceived notions on which way we go on that.

Do you want to comment on the Treasury's approach?

Mr. **Beck**. Well, I would rather comment more generally on the whole issue and try to be a little specific later.

We really believe that this effort to try to establish a minimum approach to try and put a safeguard in against dividending offers one of the most unique and perhaps potentially sound approaches to try and get at this issue.

Our concern is that the way it works is that the minimum tax always then becomes the tax. There is no advantage to the tax preference items. There is no advantage from capital gain.

Chairman **Stark**. Speaking of that, it seems to me that what you are saying there, if I understand correctly, is that if you get to deduct, by our definition, let's say one company gets to deduct 70 percent of its income as dividends, that then you are getting somewhat less advantage, say, than if you own municipal bonds. You are only getting a 70-percent boost and the stock company is getting 100 percent because you are losing that deductibility if you are paying a gross tax in a sense.

I am not sure that that can't be adjusted. I recognize that and that is something that the staff has fooled with. I can see some imbalance there.

Mr. **Beck**. Mr. Chairman, we would agree. In fact, both Bob's testimony and my testimony really stays pretty firm on the point that we believe the problems can be fixed, that there are adjustments that can bring down the total level of tax for the industry and fix the current imbalance between the two segments of the industry.

Now, I am not personally a very strong proponent of segment balance per se as being a guiding issue. I think it is important to test any proposal after the fact by looking at segment balance to try to see whether you have achieved reasonable balance between the two major elements of the industries.

I believe, despite some other comments that have been made, that somewhat over 50 percent should be paid by the mutuals. Somewhat less than 50 percent should be paid by the stocks.

If the current tax advantages that are present for the stocks continue into the future, totally ignoring the stock proposal, I would say that in 5 years you had better start asking the stocks to pay 60 percent because they will be getting a much larger share of the business.

Chairman **Stark**. Let me ask this for a minute, because this is where I started out a few months ago with either of you gentlemen.

Can you, either with respect to a particular policy, if you had to make the calculation, or with respect to your own companies in any one year, how close can you get to saying exactly how much of your premium income is redundant at any one point in time?

Mr. **Beck**. It is very, very tough and, as you know, Mr. Chairman——

Chairman **Stark**. If we fix the rate, and I am not that familiar with how you all price and what those considerations are. One of the things we thought about is if that is a possible calculation, although the complexity in it seems horrendous, that then it solves our problem, does it not?

The redundant part of the premium is, in fact, then, that portion of the dividend which is a discount like Ford's rebate on its cars and the balance is some kind of a return to the policyholder which is not a redundancy, and then we could fight over how that ought to be taxed, 25 percent or at what level or as you will remember, we even talked about 1099's which we have long since forgotten.

And I gather that that would be an impossible calculation.

Mr. **Van Fossan**. Extremely difficult, Mr. Chairman.

Chairman **Stark**. Would it be expensive or difficult or both?

Mr. **Beck**. Without regard to expense.

Chairman **Stark**. Do you know of anybody who has calculated it and said—my God?

Mr. **Beck**. The only areas where it becomes somewhat more manageable, we think are on products like universal life and variable life where, because of the unbundling, you have some real potential to make that kind of evaluation, particularly for the part which is not the insurance part.

And that more sharply focuses on the area of differences between stocks and mutuals, the amount of money that is left over and what the stocks and mutuals can jointly do competing in the marketplace.

I share the view that we ought to find a way to have product neutrality from a tax standpoint in the marketplace. If we could find an easier way to help define it, we sure would be at you with that.

But in variable life and universal life, we can illustrate it and that was the intention of that chart up there.

Chairman **Stark**. The objection to using the imputed equity at some rate, whether it reflects earnings in other industries or if it is a rate we pick out of the air to achieve values, if we were silent in the 23-percent rate that we have used in our example, and that was just at the rate that Mr. Moore and I decided to scribble on a piece of paper and toss a coin to see what we could come up with without any reference to whose earnings it was, whether it is portfolio earnings, then your only objection, and as I can see, the only difference is that some companies have more surplus than others, and that causes some problems within your segment.

Mr. **Beck**. Forgetting what goes in the total definition of equity, but just focusing attention on the rate, and Bob, you can add your point, too. The problem—and the minimum should apply to both stocks and mutuals—is that the minimum should not be the only way you get taxed so that you can normally get taxed on economic income with credit for tax preference items, credit for losses which many of us have had in different branches of the business.

Two years ago, we lost $300 million on health insurance. Any system that doesn't permit us to reflect those losses on a branch, I submit, Mr. Chairman, is out of balance. But the concept of using that imputed rate for having a standby protection against the people avoiding taxation improperly, I think, is totally sound, and we support it.

Chairman **Stark**. Mr. Moore.

Mr. **Moore**. Mr. Chairman.

Gentlemen, I would like to thank both of you for testifying. Your testimony has been very helpful and I think that you are proving what we suspected to be the case, and that is that the biggest issue among the mutuals is the return on equity question.

The ownership differential question.

Mr. Beck, I want to thank you for your testimony. You have given us what we hoped we would get from the industry and that is a very detailed analysis of what this does.

Your charts and your calculations are particularly valuable to us. Let me assure you that none of us feel comfortable with these tax equity figures. I assure you that it was not intentional, and thank you for that detailed information.

Mr. Van Fossan, I would like to ask only one question and that is, is the crux of the issue with your industry really the amount of the return on equity with the 23 percent or is it the return on equity concept? In other words if that was ratcheted downward to say 20 percent or 15 percent, would that be of interest to the industry or would you reject that entirely?

Mr. **Van Fossan**. We would not reject it entirely, but I would like to comment a little bit extensively if I could on that, Representative Moore.

It seems to me that the confusion has taken hold over the ownership differential area can best be addressed if we break it into a couple of component pieces. One of the difficulties that has reared its head obviously, as we analyze the permanency of the taxation basis for the mutuals was caused by combining the ownership differential with the minimum tax to be paid, and I would suggest to you that if those are separated, there should be a minimum in order to preclude the mutuals from dividending out of any tax liability.

But it is when you combine that in your equity return formula that you created what we feel is an almost impossible monster for us to live with.

Now, let me go to the equity return issue itself. Not total agreement among the mutuals, some strong disagreement to anything that would result in what anyone could describe as a tax on surplus. We feel, a number of us, that there is, however, within your proposed equity return approach, the basis for arriving at the amount of the ownership differential.

As I stated in my testimony, we think that if you use that equity ownership issue, the equity return to determine the appropriate level of dividend deductibility then use the dividend deductibility as the basis of arriving at the exclusion, then you will have reached the goal you were after, and you will have done it on a basis that accommodates the needs of the business.

Mr. **Moore**. Then you and Mr. Beck differ on this?

Mr. **Van Fossan**. No, I don't believe so.

Mr. **Moore**. Mr. Beck seems to be saying with some improvements on the formula, it may be possible to arrive at a return on equity and thereby use that in calculating the tax for a mutual company, if I understand his testimony right.

You seemed to be saying you jumped that entirely and go back to the concept of stopgap of coming up with some kind of 7.5 percent or 8 percent or 5 percent lack of deductibility of your dividends.

Mr. **Van Fossan**. No, apparently I did not make myself clear. I am not proposing that you junk the return on equity approach entirely. I would propose to you that you use the return on equity approach, that we hammer out what is the appropriate equity number, what is the appropriate rate number and there are differences of opinion among all of us, on what those should be.

But we finally agree on those. We then put those two together and they result in a figure. That figure then does not go into the law. You use that figure and interpolate it into whatever the equivalent amount of dividend deductibility that would result in.

You will have reached the goal in precisely the same fashion you started out and end up with a far more equitable system of taxation.

Mr. **Moore**. But what you are saying is that we do get away from trying to impute income on equity and get to just a simple limitation of dividend deductibility. That is the end result.

Mr. **Van Fossan**. That is the end result.

Mr. **Moore**. Let me simply take issue. My time is running out, and I don't have the time to dispute that at length. However, I do not accept for a minute that this return on equity design is a tax on surplus.

That is your definition of it. I don't accept that. Furthermore, it has been indicated by several people who have come to see me that what companies will do is simply reduce their surplus to reduce the taxes. I don't think that is the case. Proper business practices won't let you do that.

Your boards wouldn't let you do it. Insurance regulators won't let you do it. The concept is a way of computing the income that you are making on capital to try and equate you with a stock company and then come out with a proper tax base.

So that was what was intended when we put this together, not a tax on surplus. I do thank both of you for testifying.

Chairman **Stark**. Mr. Guarini?

Mr. **Guarini**. I want to thank both of you gentlemen for your testimony, and the help and advice that you have given us. I would just like to clarify in my mind a couple of points. You would accept a figure, whatever it would be, 15 or 18 or 20 percent, et cetera, providing that it was redefined and provided that it also applied to stock companies as well as mutuals.

Is that the point you gentlemen are making?

Mr. **Van Fossan**. Yes, sir, if I could, Mr. Guarini, going back to the comment the chairman made this morning, I think anyone would recognize the extreme difficulty in trying to pull out of the air the appropriate number for limiting the deductibility of premium.

Mr. **Guarini**. You have no number to suggest?

Mr. **Van Fossan**. No; all we would be suggesting is use your proposed system, your proposed structure of your equity return to determine what the appropriate dividend limitation should be. That is all I am suggesting and that it would get at the very issue the chairman raised earlier this morning.

It would lend substance then to why you came up with the specific figure rather than a 7.5 or a 10 or a 15 or whatever it might be.

Mr. **Guarini**. Could you write out for us your proposed definition?

Mr. **Van Fossan**. We would be glad to.

Mr. **Guarini**. And help the committee with your definition of equity or surplus or whatever it would be, and give us an idea as to whether or not that same formula should apply to stock companies as well.

And would you also provide what you feel the percentage might be as a fair percentage to arrive at a proper tax.

Mr. **Van Fossan**. We will be most pleased to make available to the committee no later than Monday or Tuesday of next week.

Mr. **Guarini**. Thank you, Bob.

Let me ask you in addition, how do you crank in the differences between mutual and stocks when it comes to tax preferences and tax benefits such as depreciation allowances and tax credits and tax-free bonds.

Do you have any suggestions on that?

Mr. **Van Fossan**. Basically, the difficulty on those, I think, becomes quite clear. You somehow, some way, must give equal treatment to such fundamental investment areas as how we depreciate our real estate, how we accrue the discounts on bonds, how we take capital gains into our tax structure.

I would certainly hope that no one is proposing that stocks and mutuals should be treated differently on those issues.

Mr. **Guarini**. But is there a way of working it out that would be the correct procedure?

Mr. **Van Fossan**. We are confident there is and we again would be most willing to work with the committee to provide input in that area.

Mr. **Guarini**. Can you suggest a wording in that regard so that we could examine it and have something that would be fair and acceptable to the entire industry that would not be one-sided, because you know, we need to have the acceptability of both parts of the industry.

Then, in regard to the stock subsidiaries, you feel that 80-percent formula is a proper formula and is workable? Will you comment on your thoughts as to whether or not it would give mutual companies an advantage if they are able to make use of stock subsidiaries that they would own?

Mr. **Beck**. Well, we would find it very hard to support the 80-percent suggested guideline in view of the fact that we don't believe that a stock subsidiary of a mutual should be taxed like a mutual.

We think that a stock subsidiary of a mutual is, in effect, like almost any other investment that an insurance company makes. When we invested money in the Alaska Pipeline, or we invested money in Chrysler. Or we invested money in International Harvester.

The last two weren't particularly good investments initially. The Chrysler one turned out to be a good one, but we had to do the same thing with our stock subsidiaries.

I would suggest, Mr. Rolland suggested, that if the balance between the segments of the industry, mutual and stock, are fair and reasonable, the whole question becomes somewhat moot. It only becomes significant to the stocks if there is an unfair competitive advantage in their form of taxation as compared to the mutuals.

Mr. **Guarini**. You don't feel that a mutual could use a stock subsidiary to an unfair advantage by the way it would write policies or manipulate it?

Mr. **Beck**. No; on the contrary. Not having the capacity to have a stock subsidiary if there isn't some reasonable balance between the two segments of the industry places the mutual industry in an almost impossible position.

Mr. **Guarini**. Let me ask you, Mr. Beck, in regard to the universal life products, as you know, TEFRA had temporary guidelines on universal life insurance contracts and there were certain modifications which have been suggested to strengthen those guidelines and make them permanent.

Would you comment on these universal life products and where we should go in that regard?

Mr. **Beck**. Well, I, too, share the view expressed by Mr. Van Fossan earlier that universal life, while it is new in its form, is really not unlike products that were sold like buy term and invest the difference in earlier years.

And it is the trend in the industry for stock companies especially to move increasingly toward participating contracts. I hold no grievance against universal life. I have some personal concerns about it, but many of my associates and friends do sell it.

My big concern is not so much about universal life per se, but some universal life products. I am concerned that when any product gets so close to being an investment product with only a thin veneer of life insurance for tax purposes, it puts at risk the whole tax approach for the basic life insurance product, which has enjoyed some special tax advantages through the years and properly so, and desired by Congress.

I think that the minute you get a universal life product or any other life insurance products so close to an investment that it is hard to distinguish between a mutual fund and the product, you have to have very serious questions about what the definition should be.

At this moment, I support, except for the kind of possible exceptions that the chairman referred to, the definition as proposed by Stark-Moore.

Mr. **Guarini**. It is causing an aberration and imbalance in the industry.

Mr. **Flippo**. Gentlemen, I appreciate your testimony.

There was one area that I would like to pursue. Mr. Van Fossan, did I understand your testimony to state that you felt the stocks should recover phase III accounts over some period of time, because it was a tax benefit enjoyed in the past by stock and not mutuals?

Mr. **Van Fossan**. As I stated, Mr. Flippo, we did support the one option stated in the Stark-Moore proposal, which was to cover the effect of causing the stock companies to take that phase III deferral back out of surplus back into income pro rata over a period of years, which I believe was your option one as stated in the original proposal.

Mr. **Flippo**. So, you would recommend that the stocks recover phase III.

I wonder if that is not inconsistent with the grandfather treatment accorded under the MODCO transaction last year for mutuals and stock in that there was no requirement to recover the tax benefits that many companies enjoyed.

I think there was a GAO study that indicated that through the effective use of MODCO that there was about $5 million in revenue lost in 1980 and 1981. According to this GAO study approximately 90 percent of these benefits accrue to mutual companies.

At that time, I believe you argued for grandfather and passing on beyond that. Would your present position now be consistent with your position then?

Mr. **Van Fossan**. I believe so, Mr. Flippo. The issue of the MODCO, I will speak only in the case of my own company. Our decision to utilize the obvious tax advantages that were implicit in MODCO was based on the receipt of a private letter from the Internal Revenue suggesting that that was totally appropriate.

Based upon that, we took that action and then obviously when the Congress saw fit to disallow that in the future, it was simply gone.

Mr. **Flippo**. But it was a revenue loss as a result of you following the tax law and you operated in accordance with the law, no one is suggesting that you did not.

Mr. **Van Fossan**. There is no question about that.

Mr. **Flippo**. If you don't consider that inconsistent, would you be willing to recapture the revenue loss that you—the tax benefit that you obtained in 1980 and 1981 as a result of the use of MODCO?

If you favor recapture for the stocks under phase III, a tax benefit, would you favor recapture of that?

Mr. **Van Fossan**. I obviously would not, Congressman.

Mr. **Flippo**. Well, it just appears to me that your position is rather inconsistent in regard to that matter. Thank you very much.

Chairman **Stark**. Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

I was most interested in hearing about the ownership differential and we have exhausted that topic, I think. So just a few quick questions.

One, Mr. Lebed and Mr. Rolland mentioned that they thought that policyholder loans over $50,000 affected them maybe 1 percent or less. Would you give us any information, maybe not right now, on policyholder loans of over $50,000, and whether they are individual loans or corporate loans?

Mr. **Van Fossan**. We would be most happy to do that, Mrs. Kennelly. We may have some difficulty in distinguishing between individual and corporate insurance. We don't maintain, at least some of us do not maintain our records in a fashion that would enable us to distinguish that.

We obviously can distinguish in a readily available fashion the size of our policy loans outstanding and that we will comply and have this in your hands the first of the week.

Mrs. **Kennelly**. And if you could find the other, I would appreciate it.

Mr. **Van Fossan**. In my own case, I am doubtful that we can.

Mr. **Beck**. Well, I believe in many cases the problem will be how can you add up the very policies that someone may have with the company to get up to a total? It is easy enough to look for individual policies, but for all policies owned by the individual that is where the problem comes in.

Of course, the problem is magnified by the fact that people can own insurance in more than one company and we have no idea what that adds up to.

Mrs. **Kennelly**. That is true.

[The following was subsequently received:]

The Prudential Insurance Co. of America,
Newark, N.J., August 10, 1983.

John J. Salmon,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

Dear Mr. Salmon: In response to your memorandum dated August 1, 1983 to Bob Beck, attached you will find a corrected transcript of the testimony.

During the hearings, Mrs. Kennelly requested a "break-down" of Prudential policies with loans of $50,000 or more. Prudential has 1,060 policies with loans of $50,000 or more. Of these, 223 policies are owned by individuals and 837 policies are owned by corporations.[1]

If I can be of any further assistance to you in any way, please let me know.

Yours truly,

Michael Chesman,
Vice President and Tax Counsel.

Mrs. **Kennelly**. Let me ask you about the basis for life insurance contracts. The Stark-Moore proposal suggests premiums be reduced at surrender of the contract by the cost of the term insurance. So you would have to figure out the policyholder's investment in the policy this way. Do you agree with this proposal? Can you do this, or would you have another suggestion for us?

Mr. **Beck**. To either one?

Mrs. **Kennelly**. Either one.

Mr. **Beck**. I would object to it. We don't do that when someone sells a car. We don't do that when someone sells a house. I find it difficult to believe that a taxation approach should be tried out or started for life insurance that is uniquely different from that which is done with any other product.

Mrs. **Kennelly**. Thank you, Mr. Beck.

And I also appreciate your charts very much. This illustrates something I have been trying to get across in these discussions. Here we are trying to treat you in this proposal like other corporations, and the result comes out that the insurance industry will be taxed higher than other corporations. I thank you very much for putting these facts and figures in because I don't think everybody appreciates the extent to which the insurance industry will be taxed beyond other industries.

So, I appreciate those charts.

Mr. **Beck**. We appreciate your comment in recognition of the facts.

Mrs. **Kennelly**. Thank you.

Mr. **Guarini** [presiding]. Thank you.

Mr. Ed Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

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[1] As of December 31, 1982, Prudential had 17,861,142 policies outstanding. Thus, policies with loans of $50,000 or more were less than .006 percent of total policies.

I want to thank the panel for your testimony. You indicate on one of the charts that your taxes as a percentage of equity under Stark-Moore would be 6 percent; under stopgap, 2.5 percent.

Mr. **Beck**. Correct, sir.

Mr. **Jenkins**. What would it be if stopgap expired?

Mr. **Beck**. Obviously, if stopgap expired with some extra price, then that percentage would go up slightly.

Mr. **Jenkins**. Would it be more than 6 percent? Would you be better off under the Stark-Moore proposal?

Mr. **Beck**. We are using the Stark-Moore definition of equity, which is more than we believe it should be. If you were to use the normal definition of equity, for the total, instead of being 2.5 percent it would be 4.8 percent. It roughly doubles because the amount of adjustment to equity by adding in the other elements almost doubles the equity totals.

Mr. **Jenkins**. As I understand it, the mutuals have a real problem if we don't come up with something by the end of the year, do you not?

Mr. **Beck**. Well, I believe the whole industry does, but we have a very special problem, yes.

Mr. **Jenkins**. Because of the stopgap provisions now?

Mr. **Beck**. Well, three alternatives, sir. We can extend stopgap; we can return to the 1959 act; or we can seek new permanent legislation.

Mr. **Jenkins**. What if we return to the 1959 act? Where would you be as a percentage of equity?

Mr. **Beck**. Well, in our case, if you will look at chart No. 2 under "stopgap," we paid, using that equity number—the Stark-Moore definition of equity—we paid 3.1 percent. If we would have related to normal definition of equity, it would have been about 6 percent.

We pay $200 million as a company. If we return to the 1959 act, our taxes in 1982 would have been $330 million. If we went to Stark-Moore—and now I am using the 1984 taxes—the taxes for my company would go to $570 million. Now, $570 million may not alarm you, but when a single company in the life insurance industry pays more than 1 percent of all the taxes for corporate America, I suggest that there is an imbalance.

Mr. **Jenkins**. I don't think you would get any argument from any member of the panel that $500 million is not a substantial tax amount.

Mr. **Guarini**. We are very proud that you come from New Jersey.

Mr. **Beck**. If we don't do something, we won't be there long or anywhere else.

Mr. **Jenkins**. Mr. Flippo was asking two or three questions about the overhang and the concern of the stocks. All stocks are affected by that, big and little alike. I guess the concern may be that there have been some benefits from the standpoint of underwriting gains through the years that were under the law at that time, that you have not paid any taxes on. I would assume that the stocks feel that, since they had the 50-percent carryover, they shouldn't have to pay any taxes either.

You take the position that those are two distinct and different——

Mr. **Beck**. They are so far apart, I find it hard to see them being close together. One, we paid so much tax on investment income, we never got a chance to pay a tax on underwriting, and it really isn't a relevant comparison.

Mr. **Jenkins**. It is amazing how witnesses from different segments of the same industry can see things so differently.

Mr. **Beck**. Mr. Jenkins, we do agree. Actually, that is why we share the conviction that some real progress is being made by this subcommittee. If the problem were easier, we would have gotten together a long time ago. And there are honest differences of opinion—and some are not always that honest—but there are, even among those who are really trying to look objectively at it. It is hard to find the truth.

Mr. **Jenkins**. You wouldn't support a premium tax and forget the whole thing?

Mr. **Beck**. Maybe that would be the answer.

Mr. **Guarini**. There have been many programs that have been pushed over to the States for the States to assume responsibility. Has it been the insurance companies that some States have looked to for any kind of taxes to make up for the revenue that they have been receiving from the Federal Government? Can you comment on that at all? Is there a movement in the States whatsoever to extract more taxes from the insurance industry?

Mr. **Beck**. Here and there, there is a movement to increase premium taxes. But if one State increases, the retaliatory principles go into effect in other States so that helps keep the taxes in line and keeps the States from individually increasing taxes at too great a rate.

Premium taxes have gone up very modestly through the last 20 years, and, in fact, one of the important reasons why premium taxes went up modestly, that the committee should examine, is that the gains have grown modestly and also companies have reduced premiums in order to be competitive in the marketplace. And among all the products around, there are very few products that have had as consistent a reduction in the cost of the product as has been true about life insurance.

Mr. **Guarini**. Well, there has been some movement, but not to an alarming level; is that right?

Mr. **Beck**. Yes, sir; very modest.

Chairman **Stark**. I thank the panel very much and anticipate your continued cooperation with the members and the staff.

[The following was subsequently received:]

The Prudential Insurance Co. of America,
Newark, N.J., August 1, 1983.

Re hearings on the taxation of life insurance.

Hon. Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

(Attention of John J. Salmon, Chief Counsel).

Dear Mr. Stark: On July 28, 1983, I testified before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means concerning the discussion proposal for a permanent life insurance company tax law. At those hearings, I stated our belief that the aggregate tax burden imposed on the life insurance industry should not exceed $2.5 billion. This letter explains very briefly for the record how we arrived at this aggregate revenue level.

1. Return on equity comparison

A basic principle reflected in the Stark-Moore proposal is that corporate profit, upon which taxes should be paid, can be approximated by imputing a return on equity. As explained in the written testimony of Assistant Secretary John E. Chapoton, this approach is based on the notion that, in the long run, an enterprise needs to earn a competitive rate of return on its equity to remain in the business.

If the rate of return on equity and the average effective tax rate of life insurance companies were the same as those of corporations generally, taxes as a percentage of equity would also be the same. For corporations generally, taxes were 2.1 percent of equity in 1982. Applying this rate to the aggregate surplus of life insurance companies (as measured under the Stark-Moore proposal, about $83.5 billion) would yield a tax of $1.8 billion.

2. Percent of total corporate taxes comparison

Another approach to illustrate that a tax burden of more than $2.5 billion on our industry would be excessive is to examine taxes on life insurance companies as a percentage of total corporate income taxes.

Initially under the 1959 Act, life insurance companies paid 2.4 percent of total corporate income taxes. By the late 1970's, that level had risen to 4.6 percent. This increase was caused because our tax was based previously on an investment income formula that disproportionately increased our taxes as inflation drove up interest rates.

Total corporate income taxes in 1982 were approximately $49 billion. At 2.4 percent, the life insurance industry's fair share of taxes would be only $1.2 billion. Even at 4.6 percent, the life insurance industry's share of taxes would be only $2.25 billion.

In sum, we believe that, when compared with the tax burden on corporations generally, the imposition of taxes in excess of $2.5 billion on our industry would be very unfair.

I very much appreciated the opportunity to testify before the Subcommittee with respect to our industry's and our company's tax burdens. I would be happy to answer any further questions or provide any additional information that would be helpful.

Very truly yours,

ROBERT A. BECK.

Chairman STARK. The next panel consists of the National Association of Life Insurance Co's., represented by Mr. Verlander; the Investment Life & Trust Company, represented by Mr. Moore, its executive vice president; the National Insurance Association, represented by George Hill, its president and chief executive officer; the Life Insurers Conference, Mr. Robert Greer, its president; and the State Farm Life Insurance Co., represented by Mr. Roger Joslin, a member of the board of directors.

I am going to state without prejudice to the remaining witnesses, I felt the two principal segments represented the major differences, or one of the most tricky differences, in the proposal. From now on, the Chair will enforce the 5-minute rule both for witnesses and the members and the Chair; and because there are many panels who are scheduled later in the list who would probably like to get to dinner today.

Having said that, I would call on Mr. Roger Joslin.

STATEMENT OF ROGER JOSLIN, MEMBER, BOARD OF DIRECTORS, STATE FARM LIFE INSURANCE CO., ACCOMPANIED BY WILLIAM O. BURNS, VICE PRESIDENT AND TREASURER; AND STANFORD G. ROSS, COUNSEL

Mr. JOSLIN. My name is Roger Joslin. I represent State Farm Life Insurance, Bloomington, Ill.

We share your desire for the enactment of a fair, equitable and permanent solution to the problem of taxation of life insurance and life insurance companies. We commend you and Congressman Moore and your staffs on the establishment of a sound fundamental framework for solving this problem. Some modification will be required, of course, but we think that that modification can be accomplished and that it can be accomplished this year.

We have submitted a written statement for the record and we would like to elaborate on key points in that statement for the record.

There have been many people who have and will comment about the level of taxation being too high for the life insurance industry. We share that concern. We feel that you will respond to that concern. And, as you respond to that concern, we believe that there are a couple of areas that you should direct your attention to. One of these areas is the transitional rules in terms of the reevaluation of life insurance reserves and the other is the ownership differential.

First, I will comment on the transitional rules and the reevaluation of life insurance reserves. The 1959 act was an incredible aggregation of real and artificial provisions. By and large, for nearly the first 20 years at least it accomplished its objectives. We probably should declare that act a success and go on to a new act of 1983 and declare a fresh start.

We do not believe that there is any windfall to be obtained through the reevaluation in giving a fresh start. For example, we elected the 818(c) section, as many companies did. We did not obtain full tax benefit. We could not elect in or out. We had to make the election at one time and stay with that election. To bring all of the actually somewhat inflated reserves that are on the books for tax purpose back into income under new law would be unfair.

It would be unfair in another sense in that companies are in differing situations. Some have full tax benefit. Some have partial. Some have very little. We believe a fresh start is most appropriate. It would be appropriate as part of the adjustment of the total level of taxation.

The second area that we mention, not because it is so important to us but simply because we feel it is a proper manner for adjustment, is the ownership differential. We do not have any major comments to make in that area except that we point out, as you well know, that it does not make allowance for differences among companies. There are a number of methods to adjust it, I am sure, that makes allowance for individual differences among companies which will both make it fair in its application to individual companies and also lower the revenue level to an appropriate level. Possibly in that process you can reach what may be a better balance between the various segments in the industry.

We don't agree with specific revenue target nor a specific balance between the segments in the industry, but do believe that you can judge the results of proposed legislation by that balance. Perhaps through adjustment in these two areas you can address the major problems. Stock insurance companies would benefit most from a fresh start to reserves.

We thank you for the opportunity to be here and look forward to the opportunity of working with staff and you to create a good and a very successful program.

[The prepared statement follows:]

Statement of Roger Joslin, on Behalf of State Farm Life Insurance Co.

Mr. Chairman and members of the subcommittee, my name is Roger Joslin. I am a member of the Board of Directors of State Farm Life Insurance Company. I appear today in the place of Edward B. Rust, President and Chief Executive Officer of State Farm Life Insurance Company, who regrets that prior commitments prevent his attending this hearing. Accompanying me are William O. Burns, Vice President and Treasurer of State Farm Life Insurance Company, and Stanford G. Ross of the Washington law firm of Arnold & Porter.

State Farm Life appreciates Chairman Stark's invitation to participate in this important hearing. We commend Chairman Stark, Congressman Moore, and their staffs for their conscientious efforts. We wish we could testify in support of an agreed-upon consensus position, but it may be in the nature of this highly competitive industry that there will always be conflicting views. From our vantage point, the touchstone of tax policy should be to treat all segments of the industry fairly and to avoid creating tax provisions that lead to manipulative practices. We believe the proper policy objective should be for all companies to pay a reasonable amount of Federal income tax.

In our view, the proposal released by Chairman Stark and Congressman Moore two weeks ago constitutes an impressive beginning in the development of a new permanent structure for Federal income taxation of life insurance companies. The proposal, with some changes, can serve as the framework for a simplified, single-phase structure which fairly and efficiently taxes the income of life insurance companies. Obviously, further study of its application and elaboration of details are necessary. We offer our full cooperation and assistance as the legislative process moves forward.

The tax regime for life insurance companies adopted in 1959 worked reasonably well over most of the ensuing years. In recent years as circumstances have changed, serious deficiencies have developed, and the need for a new approach after almost 25 years is now apparent. We agree with Chairman Stark, Congressman Moore and Assistant Secretary Chapoton that a "major overhaul" of the 1959 life insurance tax structure is needed.

While the task is difficult because the industry is complex, there is no reason that a sound result cannot be achieved. The industry is composed of large, medium and small companies, including stocks, mutuals and members of affiliated insurance groups, as well as affiliated groups with substantial non-insurance operations. The industry and its products are highly competitive, and affordable life insurance protection is generally available to the public. All of these characteristics can and should be preserved by a new tax regime that has a neutral competitive impact.

We believe strongly that a new system can apply fairly, can be perceived as fair and can endure, only if it is based on sound tax policy principles and realistic economic analysis. We urge the Congress, the Treasury and the industry to resist pressures to accept any proposals designed to reach a predetermined revenue goal by means of a bargained allocation of that burden between different segments of the industry.

Philosophically, we disagree with the concept of developing tax legislation based on a revenue target by industry, let alone by industry segment. Whatever revenue the government needs should be raised in a fair manner across the board, without creating tax incentives for capital movement, organizational change, or other nonproductive transactions. We must seek to avoid enacting provisions of the Internal Revenue Code which encourage misallocations of resources.

Moreover, from a realistic viewpoint, economic models and revenue projections based upon data developed under one set of rules have questionable value in predicting what will occur after drastic change in the rules. Tax legislation that ignores the probability of change when significant economic incentives or penalties are created is doomed to failure. Thus, the new system of taxation which is ultimately enacted should be fair in concept and in application, be as neutral as possible with respect to competing companies and their products, and among competing industries.

Of major concern to both providers and purchasers of life insurance, and very properly to the Congress also, is the overall level of the tax burden to be borne by life insurance. Life insurance serves an essential social function in our nation, and sudden large tax increases could prove disruptive and harmful to all involved. Imposition of a new tax structure must not be harmful to the health of the life insurance industry or to the millions of policyholders dependent on that industry.

Our company has been profitable, and we have paid substantial amounts of Federal income taxes. We will willingly do so in the future. We look for no competitive advantage in the tax law, and we consider it crucial that all life insurance companies, and other financial institutions with whom we must compete, share fairly in the necessary Federal tax burden. Tax equity and fairness, and the economic neutrality of the tax system, must be guarded carefully.

The basic concepts of the proposal are sound. A simplified, single-phase structure with only business-generated deductions makes sense as a starting point for taxation. While modification of several parts of the proposal will probably be necessary, we will not try to address all the conceivable changes that need to be considered, but will confine our suggestions to the two issues which we deem most critical. These are (1) the transition rules relating to what has been termed the Section 818(c) "overhang" under the 1959 Act; and (2) the ownership differential (i.e., the proposed limitation on the deductibility of certain policyholder dividends).

Our first suggestion is a matter of equity and fairness in transition rules. We generally agree with the proposed substantive rules governing "special deductions" and deductible additions to policyholder reserves. We agree that these rules should be aimed at providing uniformity of treatment among companies and a clearer reflection of every company's income. However, we strongly believe that taxpayers have an obligation to follow, and a right to rely upon, the law as it exists from time to time.

The 1959 Act was an incredibly complex aggregation of real and artificial provisions. It was designed to achieve revenue targets for the industry as a whole and by segment within the industry. A new life insurance tax regime based on the proposal will bear little realistic relationship to the 1959 Act. This is particularly true as to valuation of life insurance reserves. Because of this discontinuity, companies should not carry over the same reserve valuations into the new law.

State Farm Life availed itself of the Section 818(c) adjustment of preliminary term reserves authorized under the 1959 Act. We would not have done so if we had anticipated now being required to take into taxable income prior adjustments, without offsetting deductions for new business placed on the books. If reserves are revalued to the proposed standard formula, the "income" imputed to us on reserve revaluation would be substantially greater than the deductions which actually affected prior year taxes.

Since Congress is establishing new rules, we believe it is only right to start with a clean slate. In 1984, all companies should be fairly taxed by revaluing reserves on January 1, 1984, with no requirement to take prior law reserves into account over a ten-year period, as proposed. Taxpayers, including State Farm Life, that have not received full economic benefit from reserve computations under prior law should not now be required to pay tax on the "recapture" of non-existent prior tax benefits.

Our second suggestion concerns the so-called "ownership differential" or minimum tax to be applied to mutual life insurance companies.

We support the concept that mutual life insurance companies should bear a tax burden reasonably equivalent to that of stock companies. Accordingly, one objective of the tax law should be to prevent mutual life insurance companies from using dividends to policyholders to avoid tax on the investment income attributable to net worth. All companies who pay taxes, mutual or stock, should not have to compete in the marketplace with the untaxed.

However, the proposed minimum tax on mutual life insurance companies is based on an artificial formulary mechanism for measuring the "imputed" equity return to the company. The formula is described as an approximation of the rate of return "enjoyed by commercial enterprises generally," but it bears little relationship to economic reality in the insurance business. The proposed 23 percent formulary return on equity is arbitrary and could produce unreasonable results.

Clearly, there are alternative ways in which net worth and the investment earnings thereon could be realistically determined. A well-conceived formula taking into account the particular business characteristics of the company to be taxed could be expected to impose an appropriate tax burden. Serious and thorough consideration of alternatives which reflect the actual economic circumstances of each taxpayer should be undertaken, and a reasonable formula should be developed.

In this regard, we believe the most important issue to consider is the goal which is intended to be reached by whatever formula is used. We believe the goal clearly should not be to bargin or allocate overall industry tax liability as between the stock companies and the mutual companies. Any formula based on such an approach will likely prove unworkable and will need to be overhauled as soon as economic or competitive conditions change. Recent experience with the 1959 Act indicates that this is a very likely consequence.

Thus, we suggest that the proper goal should be to craft a proposal which assures that a taxpayer's choice of the organizational form in which to operate is based on business considerations only and is not affected by the tax law. In other words, if the mechanism used to calculate the minimum tax payable by a company works over time in a way which produces widely disparate results, depending on whether the taxpayer is organized, or is treated, as a mutual or a stock, then the mechanism will induce manipulation. In conclusion, we again cite Mr. Chapoton, in his testimony before this Subcommittee on May 10, 1983: "Tax provisions which cause companies to alter the form in which they do business, but not the substance of that business, should be carefully scrutinized to make sure that the reasons for their existence are viable."

We stand ready to assist Members and staff in fashioning fair and equitable tax legislation. We are submitting separately the detailed information about the probable impact of the proposal on our Company which the Subcommittee requested, and we will be happy to furnish any additional information you may desire. We thank you for this opportunity to testify.

Chairman **Stark**. Mr. Verlander.

Could I suggest to the witnesses, these microphones are of another century and you almost have to swallow them for us to hear. Pull them up close.

STATEMENT OF W. ASHLEY VERLANDER, PRESIDENT, AMERICAN HERITAGE LIFE INSURANCE CO., JACKSONVILLE, FLA., ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES

Mr. **Verlander**. Mr. Chairman and distinguished members of the subcommittee, my name is Ash Verlander, president of the American Heritage Life Insurance Co. in Jacksonville, Fla. But I am appearing on behalf of the National Association of Life Companies.

NALC has well over 350 member companies and is domiciled in over 40 States. We are predominantly small- and medium-sized, stockholder-owned life insurance companies, and we, too, want to state our agreement with the proposal, since this framework can work as a sound starting point for developing a final legislative measure.

You and Mr. Moore are to be highly commended for the tremendous amount of effort that you and your staff have devoted to studying the complex issue of life insurance taxation. I know of no taxation, as an old CPA, any more complex. The proposal that has come out is something we feel Congress, the Treasury, and industry can work with to develop a fair and acceptable alternative tax structure to the 1959 Life Insurance Income Tax Act.

Mr. Chairman, while we are willing to support the broad conceptual approach of this proposal, we are obviously most concerned with where our members, small company members, will end up taxwise when the proposal is finished. Certain changes which I will summarize subsequently may be made, or must be made, to lower the overall tax burden that the proposal would impose on the industry, and, in particular, to remove much more of this burden from our smaller companies. If this is not done, I feel that hundreds of the smaller companies would conclude that they would clearly be overtaxed by this proposal and could not compete with the giants of the industry.

We believe that not only the overall tax level under the proposal is far too great, but it causes a disproportionate increase in the tax burden to the small companies. And although some small insurance companies may benefit by the proposal, we feel most smaller companies' taxes would increase significantly. In many cases, companies' taxes would double or triple.

The NALC provided its member companies with a copy of the Stark-Moore proposal and requested data on how specific companies' taxes would be affected. To date, we received 24 responses, and as we receive more we will be willing to share them with the staff. Eighteen would have increased taxable income totaling over $23 million; six would have decreased taxable income totaling some $2 million—and one of the six is Mr. Moore's company, who is testifying in a few minutes.

The basic problem with the proposal from our standpoint, sir, is that it would eliminate the 50-percent deferral of underwriting income, and most importantly the special deductions and section 818(c) without providing us a comparable level of deductions. This greatly increases many small companies' tax base, and, accordingly, their level of tax.

Smaller companies have benefited from the tax deferrals provided by the special deductions and 818(c) method of reevaluation. I explained the continued need for these provisions in detail in my earlier testimony; therefore, I will not restate all of the justifications again.

However, I must reemphasize that for most smaller companies, both the special deductions and 818(c) are vitally important. Therefore, the NALC continues to strongly advocate the smaller companies receive at least a deduction which is comparable to the sum of the special deductions and the section 818(c) adjustment they are presently receiving.

It is difficult to decide where to draw the line between a large and small company, but we would be happy to work with you in seeking a satisfactory solution to this issue. It may be possible to scale down the $19 per $1,000 figure in 818(c) to $15 per $1,000 in the GAO report. In any case, if you require significant reserve changes, we consider it essential that the reserve overhang not be brought back into income. Smaller companies would be devastated by such unforeseen new current tax burden, even if it were spread over 10 years, it accumulated over 24 years.

We believe if a new legislative approach is to be taken with reserves, it is appropriate and necessary to give companies a new start by eliminating this overhang. It seems appropriate in light of the fact that mutual companies generally would not be effectively taxed on these amounts anyway.

Likewise, many smaller companies have a phase III overhang that should not be triggered by changes in the tax law. We believe that phase III amounts should not be brought back into income because here again it would impose severe unexpected hardships. It is quite appropriate to disregard these amounts since they were based on stock underwriting income, and mutual companies have not been taxed on their underwriting income anyway.

Moreover, many giant companies also were given their vast Modco tax savings under TEFRA amounting to billions of dollars. NALC is fully supportive of the Stark-Moore proposal concept of significant deduction for smaller companies.

We think the $4 million figure is too small and should be larger. We think also that affiliated group test is too restrictive.

On the TIA, in the essence of time I will only say that we support the TIA deduction and think it should be well beyond the 25 percent. But after hearing your question to Mr. Beck, Mr. Chairman, we would rather have the 25 percent than nothing.

We thank you for allowing us to comment today on the consumers tax, policyholders loans. With other Americans receiving tax reductions the last 3 years, we think consumers borrowing on their life insurance policies should not be singled out for tax increases.

Again, we thank you for allowing us to appear.

[The prepared statement follows:]

STATEMENT OF W. ASHLEY VERLANDER, PRESIDENT, AMERICAN HERITAGE LIFE INSURANCE CO., ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES

Mr. Chairman and distinguished members of the Subcommittee, my name is Ashley Verlander, and I am President of the American Heritage Life Insurance Company of Jacksonville, Florida. Today, I am appearing on behalf of the National Association of Life Companies ["NALC"], a life insurance company trade assocation of which I am President. Mr. Roy Woodall, the Executive Vice President of the NALC, is accompanying me. We deeply appreciate the Subcommittee's invitation to explain the NALC's initial views on the Stark-Moore life insurance company income tax proposal ("Stark-Moore Proposal") as set forth in the July 14, 1983, Committee Print.

The NALC, which is headquartered in Atlanta, Georgia, has well over 350 member companies which are domiciled in over forty states. NALC companies are predominantly small- and medium-sized stockholder owned life insurance companies. Our companies have well over 200,000 home office and field employees who provide insurance products to tens of millions of policyholders throughout the nation. The NALC has been, and looks forward to continuing as, an active and constructive participant in this process of revising the life insurance income tax law.

In announcing these hearings, Mr. Chairman, you requested that affected organizations bring to your attention any unfair or unintentional results of the Proposal and that they express their view as to the appropriate aggregate level of tax on the industry. I will seek to do this in my testimony today. However, before doing so, let me publicly state our agreement with the Proposal's sponsors that this framework can serve as a sound starting point for developing a final legislative measure. Mr. Chairman, you and Mr. Moore are to be highly commended for the tremendous amount of effort that you and your staff have devoted to studying the complex issue of life insurance taxation. The Proposal that has come out of these efforts is something that the Congress, the Treasury and the industry can work with to develop a fair and acceptable alternative tax structure to the 1959 Life Insurance Company Income Tax Act.

Mr. Chairman, while the NALC is willing to support the broad conceptual approach of this Proposal as a starting point, we are obviously most concerned with where our members will end up tax-wise when the Proposal is finished. Certain changes must be made to lower the overall tax burden that the Proposal would impose upon the industry and, in particular, to remove much more of this burden from smaller companies. If this is not done, I fear that hundreds of smaller companies would conclude that they would be clearly over-taxed by this Proposal.

OVERALL TAX BURDEN

Let me say that I am confident that you, Mr. Chairman, and Mr. Moore did not intend to impose an undue tax burden on smaller companies, or on the industry as a whole, and I am sure that the Subcommittee will be able to refine the Proposal in a fair manner after hearing our concerns, which I now will outline.

It is extremely hard for anyone to develop precise revenue estimates on any proposal for taxing life insurance companies. Thus, it has been very difficult for both its drafters and the industry to determine the revenue impact of certain provisions in the Proposal. All parties appear to acknowledge that there are tremendous uncertainties in the preliminary estimates that have been made. Such uncertainty arises for various reasons, including the lack of readily available industry data and the lack of clarity in the meaning of certain provisions described only generally in the

July 14, 1983, Committee Print. Therefore, we may subsequently learn that certain provisions which now seem acceptable in fact are unworkable because a different interpretation is intended. On the other hand, we may learn that some of our initial concerns are unnecessary. In any case, these issues will be clarified and resolved as the Subcommittee refines the Proposal.

Despite the difficulty of producing reliable revenue figures, I understand that your staff's preliminary figures suggest that the overall 1984 tax burden for our industry would be approximately $4.5 billion. Current industry estimates are even higher, and project about $5 billion for 1984.

Mr. Chairman, we believe that either figure is far too high, and that such a tax burden would be most unfair to the industry and especially to the hundreds of smaller companies which would experience a huge increase in their taxes. While our industry has not been able to agree on the specifics of a new tax proposal, I believe that all segments of the industry fully concur with the NALC's strong concerns over this excessive tax burden.

The Stark-Moore Proposal would raise industry taxes by more than twice what is being paid under the Stopgap provisions of TEFRA. It would raise our taxes far higher than what most companies would pay under the 1959 Act if Stopgap simply expired. Industry estimates that it would pay around $3.5 billion in 1984 under the 1959 Act, and, as you know, many companies have argued that even that level of tax is quite excessive, especially when compared to taxes paid by other financial institutions and industries. Therefore, the NALC urges the Subcommittee to modify the Proposal to reduce the overall tax burden.

HARSH EFFECT ON SMALL COMPANIES

Not only is the overall tax level under the Proposal far too great, we believe that it would cause a disproportionate shift in the tax burden to small companies. Although some smaller insurance companies may benefit by the Proposal, we feel that most smaller companies' taxes would increase significantly. In many cases, companies' taxes would double or triple. One company has already advised us that it would face at least a 600 percent tax increase.

The NALC has provided member companies with a copy of the Stark-Moore Proposal and requested data on how specific companies' taxes would be affected. We will be providing this data to the Subcommittee as soon as possible so that the Subcommittee will better understand the unintended impact of the proposal on smaller companies. I want to point out that most smaller companies cannot produce this data immediately. Many companies will have to call in their consulting actuaries and accountats, since they do not have the in-house personnell or data processing resources to perform the complex calculations, such as the reserve adjustments that will be required.

The basic problem with the proposal is that it would eliminate the 50 percent deferral of underwriting income, and most importantly, the special deductions, and section 818(c) without providing a comparable level of deductions. This greatly increases most small companies' tax base and, accordingly, their level of tax. For example, for my company the value of the special deductions and section 818(c) exceeds the value of the proposed 25 percent Taxable Income Adjustment (TIA) deduction by more than 2-½ times, and we would appear to get little, if any, benefit from the overly restrictive small company deduction, which I will comment on subsequently.

Smaller companies have benefitted from the tax deferrals provided by the special deductions and the 818(c) method of revaluation of preliminary term reserves. I explained the continued need for these provisions in detail in my earlier testimony before this Subcommittee. Therefore, I will not restate all of the justifications for these deferral provisions. However, I must reemphasize that for most smaller companies, both the special deductions and section 818(c) are vitally important. Therefore, the NALC continues to strongly advocate that smaller companies receive at least a deduction which is comparable to the special deductions and the section 818(c)(2) adjustment they are presently receiving. Obviously, it is difficult to decide where to draw the line between large and small companies, but we would be happy to work with you in seeking a satisfactory solution on this issue. It may be possible, for example, to scale down the $19 per thousand figure in section 818(c)(2) to the $15 per thousand figure recommended in the GAO Report based on the size of the company.

If, however, the Subcommittee nevertheless chooses to recommend a different reserve deduction basis, it should, in any case, provide smaller companies with substantially greater benefits than the provision contained in the Stark-Moore Proposal. The use of minimum state law reserves, as has been suggested, is wholly inadequate and quite unacceptable from our perspective.

In any case, if you require significant reserve changes, we consider it essential that the reserve "overhang" not be brought back into income. Smaller companies would be devastated by such an unforeseen new current tax burden, even if this were spread over ten years as in the Stark-Moore Proposal. We believe that if a new legislative approach is to be taken with reserves, it is appropriate and necessary to give companies a new start by eliminating this overhang. It seems especially appropriate to do so in light of the fact that mutual companies generally would not be effectively taxed on these amounts.

Likewise, many smaller companies have a substantial Phase III overhang that should not be triggered by changes in the tax law. Therefore, we urge that the Phase III amounts not be brought back into income because this would impose a severe, unexpected hardship. It is quite appropriate to disregard these amounts since they are based on stock underwriting income and mutual companies have not been taxed on their underwriting income under the 1959 Act. Moreover, mutual companies also were given their vast Modco savings under TEFRA, amounting to hundreds of millions of dollars.

INADEQUATE SMALL COMPANY DEDUCTION

The NALC is fully supportive of the Stark-Moore Proposal's concept that there should be a significant deduction for smaller companies. The life insurance company tax laws have long contained certain special provisions designed to aid such companies and the NALC believes that such assistance is as necessary as ever if small companies are to be able to compete effectively with larger insurers. While some people may think that almost any life insurance company is a rather large business, size is a very relative matter in our industry. Although there are hundreds of companies which have significant assets, only a relatively few giant firms dominate our business. Our smaller firms often have great difficulty competing with the massive financial resources of giant companies that may have 100 or more times our member companies' assets.

We appreciate the attempt of the Stark-Moore Proposal to assist smaller companies by including a small business deduction. However, we believe that its sponsors' intent will not be fulfilled by the current provision. This aspect of the Proposal needs to be modified to provide greater relief to small life companies. The proposed taxable income limitation of $4 million is far too low and the affiliated group test is too restrictive. Companies' incomes will frequently be substantially inflated by a loss of the special deductions and changes in section 818(c), and such companies would then often not meet the already low limits suggested in the Proposal. Therefore, we recommend that the Subcommittee increase the taxable income limit from the $1 million to $4 million scale in the Proposal to a scale ranging from around $3 million to $20 million. This would allow many more smaller companies to benefit from the deduction and would help offset the loss of some of the current law's deductions. Most NALC members can live with the $500 million asset test you have suggested. However, we do not believe that either the asset test or the taxable income test should apply on the affiliated group basis that you have suggested. Noninsurance members of a group should not be considered for purposes of the affiliated group test.

We believe that modifying the small company deduction as we have suggested would make the provision far more equitable since it would allow more small companies to benefit. Furthermore, we do not believe that these changes would have a severe revenue impact. In any case, we would like to work with the Subcommittee to refine this Proposal so that it will truly benefit smaller companies.

TIA DEDUCTION

As I noted earlier, the overall level of tax on the industry is far too high under the initial Proposal. The Taxable Income Adjustment (TIA) deduction is one means of reducing this excessive burden. Accordingly, the NALC supports increasing this deduction beyond the 25 percent figure initially proposed. The degree of increase, of course, cannot be precisely calculated at this time because it will depend in particular on the effect of other changes in the Proposal, such as the modification in the reserves deduction and in the small company deduction that we have suggested. After such other changes are made, the TIA percentage should be set so that the industry pays no more than the level of tax imposed by the 1959 Act.

ADDITIONAL CONCERNS

In closing, I wish to note that while the above points are of greatest concern to the NALC, there are other aspects of the proposal that will require refinement and clarification. For example, the suggested definition of life insurance is overly restrictive. Not only would it unfairly and unnecessarily harm many of our companies that are writing universal life type policies, but it would also eliminate some traditional policies, such as endowments and single premium policies that can in no way be characterized as abusive. We believe that the definition can be modified to avoid such unnecessary restrictions while at the same time preventing essentially investment-oriented products from qualifying as life insurance.

In addition, we continue to feel strongly that the final legislation should reflect an appropriate segment balance between the mutual and stock segments of the industry. As we and other stock representatives have explained earlier, we urge that this balance be approximately 60 percent mutual and 40 percent stock.

Finally, Mr. Chairman, I would be remiss if I did not state our opposition to the suggested limitation on policyholder loans. To deny a tax deduction for interest paid by consumers on loans by their life insurance policies would in our judgment be inappropriate. The NALC hopes that the Subcommittee will focus its legislative work on efforts to avoid abuses involving life insurance products.

I appreciate your allowing me to appear today on behalf of the NALC and the hundreds of smaller life insurance companies it represents. We pledge to you our continued cooperation and assistance in your effort to draft a fair and reasonable new tax law for life insurance companies. I now will be happy to answer any questions that you may have.

Chairman **Stark**. Thank you. We appreciate your comments.

The next witness is Mr. Robert Moore of the Investment Life and Trust Co.

STATEMENT OF ROBERT H. MOORE, EXECUTIVE VICE PRESIDENT, INVESTMENT LIFE & TRUST CO., MULLINS, S.C., ACCOMPANIED BY JERRY MANNEN, TAX ADVISER

Mr. **Robert Moore**. Mr. Chairman and distinguished members of the subcommittee, I am Bob Moore, executive vice president of the Investment Life & Trust Co., which I will refer to as ILT, a very small life insurance company in Mullins, S.C. Mr. Jerry Mannen, our tax adviser, is with me.

I appreciate the opportunity to comment before this subcommittee, and I want to thank you for considering smaller companies' particular problems in the proposed change in taxation on life insurance companies. I will comment primarily on the impact to our company.

To give you a little background of our company, since you probably haven't heard of us, we were started in 1956 and now operate in North and South Carolina only.

Some financial highlights of December 31, 1982 are as follows: assets, $28 million; revenue, $5,800,000; statutory gain, $800,000; Federal taxes, $240,000.

We have a home office staff of 23 employees and 70 agents. We have not developed any of the newer products. One of our major considerations is the tax effect that we have experienced in the past. Our tax position has changed several times over the past few years, which makes it more difficult to manage the business relative to taxes and the selection of the products we market.

Between 1973 and 1982, we reported a total of over $6,900,000 in statutory gain as filed with the insurance department, and incurred Federal income taxes thereon of over $2,950,000, which represents a high effective tax rate of over 37 percent for the 10-year period. Our tax rate is much higher than the industry norm.

You asked for some specific information, tax liability for certain years. You requested information for 1984 and for prior years. I might note that we have had no Modco agreements. My statement covered data for several years. I will summarize the 1984 numbers.

Our tax liability based on stopgap, if it were to continue for 1984, would be $165,000. Tax liability under the Stark-Moore proposal, if it is in effect, will be $56,000. The tax liability under the 1959 act, if it came back in, would be $159,000. As you can see, the Federal tax savings to ILT under the Stark-Moore proposal is $109,000. As you can see, our Federal income taxes would allow us to more effectively compete with the larger companies.

A few explanations should help in reviewing this matter. Stopgap legislation had little impact on ILT. The 60-percent small company deduction which we could fully utilize since our taxable income is under $1 million is the major factor benefiting ILT. We feel this provision is extremely helpful to us and many other small companies.

In preparing the tax liability information, a few of the proposed changes were not considered in our calculations. For example, the taxation of the amounts now in policyholders' surplus account was not considered. Although there is some uncertainty as to the impact or meaning of certain of the proposals, the above data should be helpful.

We presently estimate the proposals which we did not factor in estimating our 1984 numbers would increase our taxable income by about $75,000 to $100,000. The smaller base of revenue over which we spread our expenses means it is more difficult for ILT than for giant companies to offer products at low rates and make a reasonable profit. We will grow faster and ultimately pay more Federal income taxes.

Pricing and marketing is another subject matter. Changes in taxation to the policyholder would impact on the products we market more than the changes in the company taxation. The change in the computation of the investment in the contract would make term insurance relatively more attractive than whole life insurance. The term products carry lower profit margins.

If the savings element is invested in other than life insurance, lower earnings would result. Large reduction in whole life insurance sales which would result under this proposal would result in lower profits to ILT. I would expect that our sales effort would tend to shift more to term products under certain circumstances.

Another factor that the computation of the investment in the contract is very important to us is that we mostly have cash value type life insurance policies. Increasing the gain to the policy holder by the cost of the term insurance will lessen the appeal of whole life insurance and the use of insurance products with a savings element.

This taxation change to the policyholder would be factored into our pricing and marketing strategy. In addition, the determination of the cumulative cost of term insurance could involve a significant expense to our company.

I do not feel that the impact to ILT is typical of what the proposed law will do to many of the smaller companies. And, as I said earlier, we will save a great deal if this proposal were passed.

Many small companies will be hurt significantly through elimination of the section 818(c) election, special deductions and 50 percent deferral amount, none of which had any impact on ILT currently, although I would expect so in the future.

Twenty-five percent deduction and the small business deduction will, in many cases, not nearly offset the loss of these three items.

I feel that section 818(c) election should remain for smaller companies with perhaps a lower per thousand figure.

I feel the minimum reserve should not be required. If the subcommittee feels compelled to mandate a new reserve, it should be more conservative to track along statutory statements. Others have commented on the amount in the policyholders' surplus accounts. The effect on the small companies should be considered, if the policyholder account is taxed in some manner. I feel special provision should be made that it will not alter the benefit of the small company deduction.

Defining a small company is difficult. Five hundred million dollars in assets is clearly small. However, I believe that four million taxable income limitation in the proposed small business deduction is too restrictive and should be increased significantly, so other small companies from an income standpoint can have some relief.

In conclusion, I would like to say once again that although this proposal is beneficial to ILT and its tax liability, our situation is far from typical, and many small life insurance companies would be hurt a great deal.

One final comment: I hope the subcommittee will consider the enormous amount of administrative expense that will be necessary on a one-shot basis and continuous thereafter, in particular the proposed rules regarding the re-evaluation of the reserves.

We have estimated that the cost of implementing the proposal could be as much as $50,000, and probably more.

Mr. Chairman, and members of the subcommittee, I appreciate your sincere interest and concern over the impact of this proposal on the smaller companies in our industry. If you have any questions, I will be happy to try to answer them.

[The prepared statement follows:]

Statement of Robert H. Moore, Executive Vice President, The Investment Life & Trust Co.

Mr. Chairman and distinguished members of the Subcommittee on Select Revenue Measures. I am Bob Moore, Executive Vice President of The Investment Life and Trust Company (ILT), a very small life insurance company in Mullins, South Carolina. Mr. Jerry Mannen, our tax advisor, is accompanying me.

I very much appreciate the opportunity to comment before this Subcommittee, and I want to thank you for considering smaller companies' particular problems in the proposed change in taxation of life insurance companies. As requested, I will comment primarily on the impact to our Company.

BACKGROUND INFORMATION

ILT was stated in 1956 and now operates in only North and South Carolina. We are a financially sound Company with an A+ rating by A.M. Best & Co. At December 31, 1982, and for the year then ended, we had the following results:

	Rounded
Assets	$28,000,000
Premiums	3,500,000
Total revenue	5,800,000
Capital and surplus	3,700,000
Statutory gain	800,000
Federal taxes	240,000
Statutory net gain	560,000

We have a home office staff of 23 employees and 70 agents. We sell a limited portfolio of products on an individual basis consisting of whole life, term and annual premium deferred annuities. We have not developed any of the newer products such as a universal life contract. We are registered with the Securities and Exchange Commission and subject to all the applicable SEC requirements. ILT has 1,864,865 shares outstanding and approximately 2,900 shareholders.

Our tax position has changed several times over the past few years which makes it more difficult to manage the business relative to taxes and the selection of the products we market. Between 1973 and 1982 we reported a total of $6,923,759 in statutory gain as filed with the Insurance Department and incurred federal income taxes thereon of $2,955,809, which represents a very high effective tax rate of over 37 percent for the ten year period. Our tax rate therefore is much higher than the industry norm.

TAX LIABILITY FOR CERTAIN YEARS

You have requested information (actual and estimated) on our tax liability for prior years and for 1984 under certain situations. Please note that our taxes are decreasing now and are estimated to decrease in the near future due to operational matters unrelated to tax laws such as an increase in surrenders and an ever increasing cost of operations in general. I also might note that we have had no Modco agreements.

The following data should be of interest to the Subcommittee.

SCHEDULE A

Tax liability based on the 1959 Act for 1979, 1980 and 1981 and based on Stopgap for 1982, 1983 and 1984, assuming Stopgap is extended.

Stopgap			1959 act		
1984	1983	1982	1981	1980	1979
$165,000	$171,000	$242,000	$259,000	$276,000	$318,000

SCHEDULE B

Tax liability had the Stark-Moore proposal been in effect since 1979.

Stopgap			1959 act		
1984	1983	1982	1981	1980	1979
$56,000	$60,000	$82,000	$90,000	$92,000	$97,000

SCHEDULE C

Tax liability based on the 1959 Act.

Stopgap			1959 act		
1984	1983	1982	1981	1980	1979
$159,000	$176,000	$257,000	$259,000	$276,000	$318,000

SCHEDULE D

The federal tax saving to ILT under the Stark-Moore proposal is estimated to be approximately as follows (Difference between Schedules A and B):

Stopgap			1959 act		
1984	1983	1982	1981	1980	1979
$109,000	$111,000	$160,000	$169,000	$184,000	$221,000

As shown in Schedule D, the proposal will significantly reduce our federal income taxes and allow us to more effectively compete with the larger companies. Small companies like ILT need such relief now more than ever due to the tremendous changes taking place in our industry.

A few explanations should help in reviewing this matter:

1. Stopgap legislation had little impact on ILT. In 1982, it reduced our taxes about $15,000. In 1981, it would have increased our taxes about $5,000.

2. The 60 percent small company deduction, which we could fully utilize since our taxable income is under $1,000,000 is the major factor benefiting ILT. We feel this provision is extremely helpful to ILT and many other small companies. This provision is the major cause of our reduction in federal income taxes.

3. In preparing the tax liability information, a few of the proposed changes were not considered in our calculations. For example, the taxation of the amounts now in policyholder surplus account was not considered. ILT presently has about $1,200,000 in this account which, if taxed, would increase our taxes substantially.

Although there is some uncertainty as to the impact or meaning of certain of the proposals, the above data should be helpful in understanding how ILT would be impacted. Without doubt, the significant tax reduction is due to the 60 percent small company deduction. Also, please note that the reduction itself is largely due to our very high effective tax rate.

COMPANY TAXATION—GENERAL

The tax savings to ILT will enable us to more effectively compete in the marketplace. The smaller base of revenue over which ILT spreads its expenses means it is more difficult for it than for some giant companies to offer products at low rates and still make a reasonable profit. The tax benefit for smaller companies will allow ILT to partly offset the advantage of size. Companies like ILT will grow faster and ultimately more federal taxes will be paid and consumers will benefit from greater competition in the marketplace.

ILT is frequently in direct competition with mutual companies. The Company has paid a regular stockholder dividend for years which is not deductible for tax purposes; moreover, our shareholders are also taxed on the dividends they receive. The relative competitive position of ILT depends to a certain extent on the level of policyholder dividends a mutual company can deduct. We believe a mutual dividend is, in part, an ownership return to the mutual policyholder and accordingly should be taxed so as to level the playing field with stock companies. I feel that your ownership differential proposal is a fair and equitable provision and helps to balance the two types of ownership.

The provisions for establishing reserves as the higher of minimum state law reserves or cash surrender values will likely cause ILT to change to different reserve tables and interest rates (including possible price changes to our products) in order to lower reserves since ILT will, without changes, be paying taxes on a larger gain than shown in our statutory statements as it relates to reserves. The tax basis will be less favorable than statutory and that will affect the design of our products. Our surplus, in dollars, is small and surplus drain is important to us. The change in the tax law provides a incentive to use the minimum basis which produces lower reserves. ILT historically has used conservative reserves. A switch to the minimum reserve basis would practically necessitate using lower cash value assumptions resulting in lesser guaranteed cash values for our whole life products, thus making the products less advantageous to the consumer.

PRICING AND MARKETING

Changes in taxation to the policyholder will impact on the products we market more than changes in company taxation.

The change in computation of the investment in the contract will make term insurance relatively more attractive than whole life insurance. The term products offered by ILT generally have lower profit margins. If the savings element is invested in other than a life insurance product, lower earnings to the Company would result. As a small life insurance company, ILT neither offers nor has affiliated companies which can offer alternative investments to insurance products nor do we desire to do so. A large reduction in whole life type insurance sales, which I believe will result under this proposal, would result in lower profits to ILT. However, I would expect our sales efforts to shift more to term products.

The basis for determining the investment in the contract would likely put ILT at a relative disadvantage with its current products. We now issue only the traditional types of insurance which do not specify the cost of the pure term insurance which is built into the premium. The universal life product which specifies this charge could have an advantage since lower specified charges could be used instead of a table prescribed by law. This competitive pressure could force a change by ILT to a type policy under which the mortality charges are specified.

The computation of investment in the contract is easily the most important change in the individual taxation picture impacting ILT. Most of our sales are cash value life insurance products. Increasing the gain to the policyholder by the cost of term insurance will lessen the appeal of whole life insurance and the use of insurance products with a savings element. A small typical whole life policy of ILT issued to a male aged 35 was examined. The policy does not have a stated mortality cost so we assumed the prescribed table was the 1958 CSO mortality table. Under this proposal, the individual would have a small gain if surrendered after 20 years and a large gain after 30 years while under current law there would be no gain at either point. This taxation change to the policyholder would be factored into our pricing and marketing strategy. In addition, the determination of the cumulative cost of term insurance could involve a significant expense to the Company.

GENERAL NOTES

A. I do not feel that the impact to ILT is typical of what the proposed law will do to many of the small companies. Many small companies will be hurt significantly through elimination of the section 818(c) election, the special deductions and the 50 percent deferral, none of which has much impact on ILT currently, although they probably would in the future. The 25 percent deduction and the small business deduction will, in many cases, not nearly offset the loss of these three items.

I feel the section 818(c) election, in particular, should remain for small companies with perhaps a lower per thousand figure.

B. We do not feel that minimum reserves should be required. If the Subcommitte feels compelled to mandate a new reserve basis it should be more favorable than minimum reserves and the changes should be made only on a propsective basis.

The cumulative section 818(c) adjustment that companies have at this time should not be brought back into income. Also the policyholder surplus account should be excluded, or if it is taken back into income, I feel it should be done very gradually, (i.e., more than the 10 years sometimes allowed for tax changes), and special provision should be made that it will not alter the benefit of the small company deduction.

C. Defining a "small company" is difficult. The largest giant mutual probably thinks a billion dollar asset company is small. On the other hand, we think a company with over five hundred million dollars in assets is a right good size company. In my judgment, a company around $500,000,000 in assets clearly is small. However, I believe the $4,000,000 taxable income limitation in the proposed small business deduction is too restrictive and should be increased significantly so other small companies from an income standpoint can have some relief. This is especially necessary since the effect of the overall proposal is to substantially increase many companies' taxable income base.

D. I understand this proposal will increase the industry tax bill in 1984 to somewhere close to five billion dollars, or more than double Stop-Gap in 1982. I seriously wonder if the industry would not already be paying more than its fair share relative to other industries. Congress should also consider the increased taxes it will receive from the individual policyholder via insurance products. I do not feel our industry taxes should be increased, but if so, not substantially beyond the level of the 1959 Act.

E. A matter that seriously concerns me that is unrelated to taxation itself is the apparent will of the government, through taxation laws both to the company and the individual, to encourage persons to only buy term insurance. Despite the deaths by automobiles, accidents, etc., at an early age, most people still die at older ages: I know few persons who can afford term insurance premiums at age 65. This shifts the risk to the policyholder and away from the companies and I question if this is the desired result.

CONCLUSION

I would like to point out once again that although this proposal is beneficial to ILT and its tax liability, our situation is far from typical and many small stock life companies would be hurt a great deal. I ask also that you bear in mind the need to comply with state laws as to minimum capital and surplus requirements when considering tax laws that would take too much from certain companies.

Mr. Chairman and distinguished members of the Subcommittee, please accept my thanks for this opportunity to express our concerns, and I appreciate your sincere interest and concern over the impact of this proposal on the smaller companies in our industry. Thank you. If you have any further questions, I will be happy to try and answer them.

Chairman **Stark**. Thank you very much, Mr. Moore.

Mr. Hill, you may proceed.

STATEMENT OF GEORGE E. HILL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, WINSTON MUTUAL LIFE INSURANCE CO., WINSTON-SALEM, N.C., ON BEHALF OF NATIONAL INSURANCE ASSOCIATION

Mr. **Hill**. Thank you.

Before I proceed, I would like to say that I am thankful that you invited me here. I received your letter; however, I just received Tuesday the bill, itself, so I am a little ill-prepared to provide you with all the information that you want.

My name is George E. Hill, and I am pleased to have this opportunity to appear before you once again.

I am president and chief executive officer of Winston Mutual Life Insurance Co., located in Winston-Salem, N.C.

I have come here to testify on behalf of the National Insurance Association concerning the recently announced Stark-Moore life insurance tax proposal.

As I explained in connection with my earlier testimony, the NIA was founded in 1921 and consists of 32 member-companies who have over 11,000 employees and 5 million policyholders. The NIA principally serves the life insurance needs of black families. The stated purpose of our association is to raise the standards of knowledge and practice within the life insurance industry and to encourage thrift through the purchase of life insurance.

I have already submitted a list of the members of NIA. As I have already explained to you, all our member-companies are small businesses in comparison with the giants of the life insurance industry. What I have to say, therefore, respects the effects of the Stark-Moore proposal on small life insurance companies.

I would like to speak directly to the principal ways in which your proposal will affect companies which, like Winston Mutual Life, are small companies. I hope you will understand that I do not have exact figures, for I have not had the opportunity to recalculate exactly the impact of the proposed reserve changes on Winston Mutual Life.

However, I gather that your proposal might very well reduce our reserve deduction by approximately 10 percent in contrast with existing law. Let me point out, then, that in 1981 Winston Mutual Life had a loss from operations before Federal tax and policyholders' dividends of $1,661. This consisted of total income of $2,570,199, minus total expenses—including a $57,752 deduction for increases in life insurance reserves—of $2,571,860.

If it is true that our reserve deduction would be reduced by the Stark-Moore proposal by 10 percent, our reserve deduction in 1981 would have been smaller by $5,775, and we would have experienced, instead of a $1,661 loss from operations, a $4,114 gain from operations.

Assuming we qualified for the 60-percent special deduction for small insurance companies our taxable income would therefore have been $1,646—$4,114 times 40 percent. After allowing for the 25-percent taxable income adjustment, our actual taxable income thus would have been $1,234.

Winston Life would have an estimated equity return based on approximately $90,000 in 1981, and it paid policyholders dividends of $29,521. However, under the proposal, since the taxable income of the company before policyholder dividends is less than the equity return, then only the lesser amount, the $1,234, would be taxed. The exception to the equity return limitation on policyholders' dividends seems appropriate, and we support it.

The tax on this amount, by the standards with which you are dealing, would not be considered excessive. But for us it would complicate matters, and even the amounts involved are not trivial for a company that has a statutory loss from operations before policyholders' dividends but, nevertheless, paid $29,521 of dividends to its policyholders.

What is more, for a company like ours, whose resources are limited, your proposal would require us to recalculate our reserves for Federal income tax purposes in a different way than we must calculate them for purposes of filing our annual statements with State regulatory authorities. To us, this latter aspect of this proposal is perhaps more important than the resulting additional dollars we would be required to pay to the Federal Government.

I understand that some of the larger insurance companies that are shareholder-owned have urged the subcommittee to consider continuing to allow us to calculate our reserves in the same manner as we calculate them for regulatory accounting.

I certainly hope the subcommittee will look with favor on that request, as I am confident that the amount of money that we will have to expend in recalculating our reserves and preparing our Federal income tax return will far outweigh the increase in the amount we will pay to the Federal Government.

Needless to say, I would also hope that the subcommittee will consider liberalizing the small business deduction for the benefit of other member companies of the NIA.

In sum, Mr. Chairman, we hope that you will revise your proposal in a way that will make life simpler, or at least less complicated, for small insurance companies of the type that are members of the NIA.

Chairman **Stark**. Thank you very much, Mr. Hill.

Mr. Greer?

STATEMENT OF ROBERT S. GREER, SR., PRESIDENT, UNION NATIONAL LIFE INSURANCE CO., BATON ROUGE, LA., ON BEHALF OF LIFE INSURERS CONFERENCE, ACCOMPANIED BY F. C. McMAINS, JR., VICE PRESIDENT AND GENERAL COUNSEL

Mr. **Greer**. Mr. Chairman and members of the subcommittee, my name is Robert S. Greer, and I am president of the Union National Life Insurance Co. of Baton Rouge, La. I appreciate your invitation to appear again before this subcommittee on behalf of the Life Insurers Conference [LIC] to express the LIC's views on the Stark-Moore proposal for the taxation of life insurance companies and products. Accompanying me is Mr. F. C. McMains, Jr., vice president and general counsel of my company.

As I explained in my initial testimony in May of this year, the Life Insurers Conference is an association of life insurance companies which primarily offer insurance through the home service marketing system.

The LIC currently has 88 member-companies which are located in 20 States and the District of Columbia. Most of our members are quite small when compared to the companies which dominate our industry. As such, they have special problems and concerns that we hope your subcommittee will address as you draft a new life insurance tax law.

Mr. Chairman, let me first commend this subcommittee, and especially you and Mr. Moore, as well as your fine staff, for the exemplary effort you have devoted to grappling with the complex problems associated with the taxation of the life insurance industry. While the preliminary Stark-Moore proposal described in your recent committee print must have several important modifications to make it workable for most smaller companies, the LIC believes that it definitely provides a viable permanent framework for fairly taxing life insurance companies.

Your accomplishment is indeed remarkable. Our industry has struggled with this problem for a number of years, but despite our best efforts, we have been unable to develop an acceptable alternative approach to the 1959 act.

Yet, in a few short months of intensive work, you have been able to craft this basic structure of what we believe can be an acceptable, workable new approach that will impose a fair tax burden on all life companies, be they mutual or stock, large or small.

We applaud your efforts, and we want to work with you to perfect this initial proposal so that a new tax law for our industry can be enacted this year.

Let me now highlight the principal areas of the proposal where we believe the subcommittee should make refinements before reporting the measure to the full committee. While we feel that these modifications are necessary, we do not believe they will change the basic thrust of the proposal.

LEVEL OF TAX

The LIC is concerned over the high level of taxation that the proposal would impose and how this tax burden would fall heavily on smaller companies. We understand that current industry estimates show that the proposal would produce approximately $5 billion in taxes in 1984. This is more than double what the industry is paying under the stopgap provisions of TEFRA, and substantially more than companies would pay under the 1959 Act if the stopgap provisions expire. The LIC believes that such a dramatic tax increase is not justified and that the Stark-Moore proposal should be modified to reduce the industry's overall tax burden.

ADVERSE IMPACT ON SMALL BUSINESS

In addition to our general concern over the excessive levels of tax that would be imposed on the life industry as a whole, we are especially concerned over the proposal's direct impact on smaller companies.

The LIC has forwarded a copy of the recent Stark-Moore proposal and a tax impact survey form to its members. We will advise the subcommittee of the results of this survey as soon as it is available. For most smaller companies, it will be a significant task to calculate the tax effect of the proposal. We cannot obtain reliable individual company data simply by pushing a button on a desktop computer.

Smaller companies generally do not have the in-house actuarial and accounting staffs, or the sophisticated data processing capabilities that are needed to make the necessary computations. The reserve recalculations are especially difficult.

However, in an effort to respond to your request for specific data, Mr. Chairman, we have obtained some preliminary figures from several companies that suggest that the new tax burden on smaller companies in many cases would be more than double and in some cases over 10 times that of current levels. We have received 28 responses from LIC companies—22 will experience tax increases, 5 decreases and 1 will feel no impact.

My own company, Union National, projects that its taxes would increase by only 5 percent if stopgap expires and we simply return to the 1959 act.

In sharp contrast, the Stark-Moore proposal would increase our taxes at least 65 percent. Needless to say, we are deeply concerned over such a staggering increase, but even at these high levels, Union National's tax increase probably would be far less than that of many other small companies.

The LIC hopes that this subcommittee will not impose such a major new tax burden. Small companies, in particular, would be severely disadvantaged by the proposed elimination of section 818(c), the special deductions, and the 50-percent deferral of underwriting income if a comparable level of deductions is not provided through other provisions.

Although the current proposal fails to provide the proper level of offsetting deductions, we believe this can be accomplished rather easily within its basic framework by modifying the proposal's provisions relating to the reserves deduction, the small company deduction, and the taxable income adjustment.

I will now more fully explain our concerns over these provisions and suggest how they might be refined to produce a more equitable result.

INADEQUATE RESERVES DEDUCTION

The most troubling aspect of the proposal is its deduction for reserves which generally would be limited to the higher of minimum State law reserves or the contract's cash surrender value. LIC companies must strongly object to this provision as initially drafted.

We believe such provision would be most inadequate. Smaller companies will find it extremely difficult administratively and quite expensive to revalue reserves. We also do not believe that minimum reserves are adequate from a solvency standpoint in many cases. We continue to feel that smaller companies should be allowed to utilize section 818(c)(2). This provision has been of far greater relative importance to smaller companies than to the larger members of our industry.

If the subcommittee, however, wishes to develop a new reserve deduction, it may be viable to use CRVM reserves, with the company's annual statement interest rate and mortality tables.

If section 818(c) is eliminated and a new reserve deduction is adopted, we believe that it is essential that the so-called section 818(c) "overhang" not be brought back into companies' incomes. Smaller stock companies will face a staggering unforeseen tax burden if this amount becomes taxable. We feel that a fresh start for all reserves is quite appropriate since a totally new tax system would be implemented and mutual companies would not effectively be taxed on such amounts in any case.

Similarly, I should note at this point that we also consider it critical that the so-called phase III overhang not be brought back into income. Companies generally have not planned to include these amounts in current income and imposing such an unexpected burden can cause severe competitive hardships, especially for smaller companies, and may render some companies insolvent.

We also believe that it is reasonable and fair to exclude these deferrals of underwriting income since mutual companies have not been taxed on underwriting income under the 1959 act, and were also allowed to keep huge Modco savings under TEFRA.

SUGGESTED MODIFICATIONS TO THE SMALL COMPANY DEDUCTION

The LIC is most appreciative that the Stark-Moore proposal contains a special small company deduction. As you know, Congress has historically provided certain special tax provisions to assist smaller life insurance companies. We continue to need such relief today in order to compete effectively with the giant companies in our industry. Therefore, we heartily endorse your concept of continuing some form of small company provision.

The LIC believes, however, that the subcommittee should refine the suggested proposal for a small company deduction because it does not provide the degree of relief that we think its drafters intended. We feel that the proposed deduction is much too low. This is especially true because the proposed elimination of section 818(c) and other deductions would significantly increase most companies' taxable income and therefore cause many smaller companies to lose the benefit of the new small company deduction. Moreover, the affiliated group test is overly restrictive and would often deny this needed benefit where small life companies are affiliated with other small businesses.

We would urge that the subcommittee substantially increase the taxable income limit to around $15–20 million in taxable income and the $1 million floor to around $3 million. The proposed $500 million asset test would be acceptable to most of our members, even if it is applied on an affiliated group basis, but provided that the affiliated group test does not also apply on the basis of taxable income. We would be pleased to work with the subcommittee and other small company associations to further refine this provision.

INCREASED TAXABLE INCOME ADJUSTMENT

The LIC favors increasing the Stark-Moore proposal's Taxable Income Adjustment—TIA—deduction substantially beyond the 25 percent figure initially suggested. As I indicated earlier, the overall level of industry tax is far too high and smaller companies would feel the tax burden quite severely. The proposed 25 percent TIA is simply inadequate to make up for the loss of the special deductions, the 50 percent deferral, and, above all, for section 818(c).

In my own company, for example, the proposed 25 percent TIA would essentially offset our loss of the 1959 act's special deductions, but it would do little or nothing to compensate for the loss of the 50 percent deferral and for our loss of section 818(c).

Therefore, we feel that it clearly will be necessary to adjust the TIA percentage upward as the subcommittee perfects this proposal. The amount of this adjustment obviously depends on the revenue effect of other necessary changes in the proposal such as the refined small business deduction that we have suggested.

DEFINITION OF LIFE INSURANCE

Finally, I want to note that we believe that the proposed definition of life insurance must be refined further. We fully endorse an extension of guidelines to all products and alternative guidelines tests. However, as proposed, the definition is overly restrictive. Not only would the definition unnecessarily harm new universal life-type products, but it would also disqualify important and well-accepted traditional nonparticipating policies such as endowments and single premium products. It also would appear to restrict some forms of reduced paid-up insurance. Therefore, we believe that the final definition should be less restrictive.

Mr. Chairman, I hope these comments have been helpful in explaining the LIC's primary concerns over this proposal. We again wish to commend you and Mr. Moore for producing a viable framework for the new law, and we look forward to working with the subcommittee as you refine this legislation.

Thank you.

Chairman **Stark**. Thank you, Mr. Greer.

I appreciate the panel's response to our request on such short notice.

I would ask, some of you have alluded to the changes in the tax on your companies and to the extent you would be willing to share with the committee on a confidential basis, not to be included in the record, how this was calculated, it would be very helpful to us.

I wanted to comment to Mr. Verlander whose testimony suggested that in most cases, $500 million would include small companies. I am sure glad that Jacksonville doesn't have a football team, if $500 million is your definition of small.

Mr. **Verlander**. I think anyone in the industry where a leading company that has $67 billion of assets, if your total assets are less than 1 percent of that, you are relatively small and 1 percent of that would be $600 million or $700 million.

Chairman **Stark**. I appreciate that in the relative size of the industry, when I go home to my chamber of commerce and say that if we followed the suggestion of Mr. Greer, that rather than exempt 60 percent of the first million dollars in income, we wanted to exempt 60 percent of the first $3 million of income and phase down to $15 million to help small companies, they would probably think I climbed out of my tree because they are not that familiar with your industry and some of the size relationships.

It is a politically hard thing to swallow and I would be less than direct if I didn't say that is one of the great joys of 818(c). It doesn't stand out there quite like such a sore thumb for all to see.

We are not unmindful of that, but we are trying in creating this new structure to not create a tremendously abrupt change on your industry and I hope you will continue to work with us to see that that happens.

As to comments on the recomputation of surplus of reserves, that has also concerned Mr. Moore and myself, and the staff has also been involved and we have been toying with a variety of ways to spread that out.

It, in our opinion, is somewhat the same nature as the phase III overhang.

If the concern is that initial lapses are higher in the first few years of contracts, we have thought of phasing it in not on a level basis but phasing it in in the opposite way, so we phase it in slowly, while the income from lapses is coming in, and it might have a level impact on the companies. We are most willing to discuss with you how we can extract it from you in the most painless possible fashion, gentlemen.

Mr. **Verlander**. Mr. Chairman, the small companies, as they were building this in the early years, a lot of them were paying no tax, so in effect got no tax benefit. After 20 or 25 years in business, you now will be paying some tax and to have to pay tax on something, on a deduction that you never got a tax benefit for really doesn't seem to make a lot of sense to us.

Chairman STARK. We would certainly be willing to discuss that with you and your representatives.

Mr. Schulze.

Mr. SCHULZE. No questions, Mr. Chairman.

Chairman STARK. Mr. Flippo.

Mr. FLIPPO. No questions.

Chairman STARK. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman. I want to thank the panel for your testimony.

It appears to me that the larger stocks and the mutuals are unanimous in acknowledging and testifying to this committee, that without some special considerations for the small companies, you simply will not be competitive. I have had many of them look at this proposal and say to me that the deductions for the smaller companies ought to be increased because otherwise, your surplus will not be there to effectively compete long term with the giants of the industry. Whatever happens legislatively, you at least seem to have convinced many of your larger competitors that it is necessary for us to take some action to assure that you remain on some competitve basis.

Mr. Verlander, did you want to make a comment?

Mr. VERLANDER. No, sir.

Mr. JENKINS. One thing concerns me about the treatment of reserves—and I appreciate your suggestion that we might look at a phasedown of the $19 per thousand figure.

If a taxpayer has $100,000 in income and is allowed a $40,000 deduction—I am using a very simplified example—he ends up with a taxable income of $60,000. Paying taxes at the 20-percent rate, he pays $12,000 in taxes. Then if the Congress does away with that $40,000 deduction, the taxable income becomes $100,000 and, at a 20-percent rate, the taxpayer would owe $20,000 in taxes rather than $12,000. But if we say we want to treat you right and therefore we are going to give you a 25-percent reduction in tax liability, that reduces the tax to $15,000 as opposed to the $12,000 that the taxpayer would have been paying with the original deduction. I think that we have to be very careful.

It may look good on its face, but if we suddenly take that which you have been deducting and place it into income, we have to be careful as to the ultimate deduction that you get. Otherwise, some smaller companies might very well be placed in a punitive situation.

Mr. VERLANDER. Yes, the loss of the special deductions and the 818(c) to American Heritage Life amounts to 2½ times the benefit we get from the 25 percent tax adjustment.

In effect, we are hurt badly by that.

Mr. JENKINS. I believe I read in Mr. Moore's testimony that his company would benefit under the Stark proposal, but there are many companies that would be hurt unless we make some additional adjustments, is that correct?

Mr. ROBERT MOORE. Yes, I believe so.

Mr. JENKINS. I want to thank the panel for your testimony. I hope the committee will be able to follow the suggestions of the giant mutuals and stocks and give some additional relief to the small companies.

Thank you very much.

Mr. **Flippo** [presiding]. Mr. Vander Jagt.

Mr. **Vander Jagt**. No questions.

Mr. **Moore**. We were concerned about the impact that this proposal has on small companies.

The transition on reserves is a problem, we know that. It is a serious problem and we are working on it and we very much appreciate you all giving us information on how to handle that. You have touched on that, and it will certainly occupy the committee from now until the time the bill is finished.

Second, the overall tax burden was one that is a result of imperfect figures we got 3 weeks ago from Treasury. None of us are comfortable with that.

That will no doubt be adjusted, certainly with my help.

The impact on small companies—we tried not to raise one additional dollar of taxes.

We have not been successful with that, and we need to go back and look at the various things you touched on.

Mr. Moore, I am very pleased your company has a reduction in taxes.

Likewise, yours, too, Mr. Hill. We knew that would happen. We knew there would be a few losers, and a few winners. I am pleased to see some of the winners here.

Mr. Moore, you and I are not in a family-run business.

You testified, Mr. Moore, you thought the $500 million asset level was possibly too small, and several of the witnesses thought they could live with it.

Just to put that into perspective, information we have from a survey of the reports filed, 1,300, out of 1,400 operating life insurance companies have assets of $500 million or less, so we think we have been fairly generous with that. It may well be that the earnings levels need to be corrected which Bob Greer touched on in his testimony. We are not sure we are happy with the tax results.

Mr. **Robert Moore**. Yes.

Mr. **Moore**. I am glad to see you both back and I appreciate your testimony. I am very concerned what happens to your companies and the others in my district. I am sorry we are making regulars out of you. I would very much appreciate information on how you compute those taxes. If you can get that to me, it will help in preparing the proposal.

Mr. **Greer**. We will get that to you.

Mr. **Moore**. I assure you that there isn't a group that has more concern among this panel than the small life insurance companies and that is fairly unique.

No other business in the country has that kind of concern for small operations. You have had it since 1959 at least, maybe longer, and so I understand that. This is something that is fairly unique but it is present. None of us have any intentions of gravely disrupting your product line. We are trying to create a level playing field and the stocks and mutuals have all been very fair in saying the same thing. You guys are not really part of this and we want to try to make the tax system easy to understand. We hope you will continue to work with us so we can achieve.

Thank you.

Mr. **Verlander**. Thank you.

Mr. **Flippo**. Thank you, gentlemen, for your testimony.

Our next panel, if you would make your way to the desk, is the president of Allstate Life Insurance Co., Mr. Raymond Kiefer, accompanied by Mr. Paul Overberg, senior vice president and chief actuary; and Mr. Alan Richards, president and chief executive officer, E. F. Hutton Life Insurance Co.; and Mr. W. Hayne Hipp, chairman of the board, Liberty Life Insurance Co., who is accompanied by a former member of this panel, the distinguished Ken Holland, and Mr. Eugene F. Cater, Jr., vice president for taxes.

STATEMENT OF RAYMOND H. KIEFER, PRESIDENT, ALLSTATE LIFE INSURANCE CO., ACCOMPANIED BY PAUL J. OVERBERG, SENIOR VICE PRESIDENT AND CHIEF ACTUARY

Mr. **Kiefer**. I will be happy to start on behalf of our group.

I am Ray Kiefer, president of the Allstate Life Insurance Co., and we appreciate your invitation to testify at the hearings today.

At the outset, I would like to compliment Congressmen Stark and Moore, and the ad hoc task force which worked on this subject for having advanced a proposal which is a sound starting point for developing a new permanent tax law for life insurance.

With some adjustments and clarifications, we are sure that the proposal can produce a fair tax law, one which we can support.

Just a few words about Allstate, as I explain the impact of this on our company and some of the concerns we have. We are a relatively young company, 25 years old, medium-size stock life insurer which primarly serves middle America, which a great many insurers are finding it difficult to serve today.

Our principal personal life insurance products are guaranteed cost term insurance and cash value products. Last year 78 percent of the amount of insurance was term insurance, and just under 50 percent of our policies were term policies.

The remaining half were cash value policies.

While not foresaking our traditional markets, we are also a changing company, changing to meet the new times and opportunities, and to adjust ourselves to what we perceive as consumer needs.

We are expanding aggressively in the group insurance market, opening new distribution systems, developing new products such as universal life for all of our markets.

We regard ourselves as an innovative company, and I refer you to our written statement for details.

It is because of our product lines our markets and our plans for the future that we are concerned about several of the specific features of this proposal. The proposal as presently formulated presents Allstate Life with a very difficult future, a future which is, first of all——

Mr. **Flippo**. You are doing such a great job. Pull the microphone just a little closer.

Mr. **Kiefer**. The impact of the present proposal as I said would dramatically and drastically increase our taxes.

Second, we would be at a severe competitive disadvantage with respect to mutual life insurers and as to also other financial intermediaries. Third, premium increases would become necessary to accommodate the new proposed tax levels, and fourth, our profit levels would be greatly diminished because we issue guaranteed cost policies and therefore could not raise the premiums on existing policies and the additional taxes on existing business would have to be absorbed. Fifth, we would be inhibited in bringing new and consumer-oriented products to our markets without which we will see a greater outflow of both our existing and future business to other financial intermediaries. Last, consumer prices for term insurance will be increased, and we might anticipate less insurance will be sold.

Notwithstanding this dreary picture, we remain convinced that the present framework of the proposal can yet produce an ultimate tax law which is reasonable in its tax burden, does not place us at a competitive disadvantage with respect to our competitors, and is fair to the public and insurers alike.

In the time that is available, permit me to discuss a few of these problems in more detail.

As to the tax burden on Allstate Life, had this proposal been law from 1978 through 1982, our total tax burden would have been 2.5 times greater than it actually was for those years. That extra tax of $70 million would have reduced our December 31, 1982, surplus by 26 percent and would have reduced our ROE by 38 percent.

Taxes for 1984 are estimated to be $12.6 million more under this proposal. That in turn is a reduction of 32 percent on our ROE.

In terms of competition, we believe each segment of the industry should be expected to contribute to the total tax burden in proportion to their wealth-producing capability; their asset and reserve levels.

That calls for a 60–40 split, mutuals and stocks respectively. Our best estimates indicate that, at several different revenue levels, the proposal produces approximately a 60–40 split and therefore is appropriate in this context.

The competitive problem is just as acute with respect to our other competitors. Our share of financial assets has been diminishing. Life insurers today have about one-fourth the share of consumer financial assets as the banks and thrifts.

Yet, according to the GAO report of 1981, from 1970 to 1976 we paid over four times the taxes, as a percentage of assets, as the banks and from 1972 to 1976 we paid more taxes in absolute dollars than the banks. The increases in tax produced by this proposal will greatly aggravate that disparity.

The competitive disparity between mutuals and stocks is affected by two other factors:

One, tax increases on existing business occasioned by the proposal can be absorbed by the mutuals through their dividend process and passed on to the policyholders. That cannot be done with guaranteed cost policies issued by stock insurers; two, unlike stock companies, mutuals would not be effectively taxed on reserve releases as they are fed back into income over the 10-year period.

As a consequence, mutual company profitability would not be as adversely affected as the stocks. That would translate directly into the price of products, making stock insurers less competitive.

The consumer will obviously be disadvantaged by the increases in the cost of insurance. In addition, the changes proposed in the definition of life insurance and annuities would deprive the consumer of flexibility and choice of products.

Many consumers, hoping to receive better values on their existing cash value life insurance, would have to turn outside the life insurance industry. The proposal will disrupt markets but produce little additional tax revenues in the process.

Permit us to offer some solutions to these problems which can produce fairness to consumers and insurers alike.

As to reserves, we agree that a single method ought to be applicable to both existing and future reserves. We endorse the Stock Company Information Group's suggest that the reserve method be the Commissioner's reserve valuation method or the cash value, if greater.

The reserve overhang on existing business should not be forced into income. Since mutual insurers would not effectively be taxed on such reserve releases, equity requires such treatment for stock insurers.

In addition, there is ample precedent in tax law and policy for such treatment when there is radical change, as here.

We offer the 1969 change in reserving techniques of banks and thrifts as well as the 1976 and 1982 deferred limitations for domestic international sales corporations. Forcing the reserve overhang into income over a 10-year period adds about $23 million per year to our gross taxable income. This transaltes into $8-plus million per year in tax.

We applaud the ownership differential concept contained in the proposal. Some fine-tuning is necessary, however. We urge the subcommittee to reconsider the Stock Company Information Group's suggestions as to additional items to be included in calculating surplus for the purposes of the deduction as well as a more appropriate rate of return.

We also applaud the tax treatment of stock subsidiaries of mutuals as mutual companies. However, a test of more than 50 percent should be used rather than 80 percent if the subcommittee wishes to achieve maximum compliance with the intent of the measure.

There is a fifth option to consider with respect to the phase III overhang, that is, do not take any of it into income. Once again, there is justification for such treatment both in equity and in tax policy. As to tax policy, we offer the same considerations as were discussed under our treatment of reserves.

Equity would dictate such treatment because mutual company operating gains in the past were not subject to tax. Those gains flowed into surplus would not now be taxed. The phase III account was designed, at least in part, as an offsetting item for stocks against the lack of tax on mutual company underwriting gains.

On the individual tax items, we support the alternative test concept of premium and cash values. However, we believe the existing TEFRA rules for universal life should be extended to all life policies.

We believe the TEFRA rules accomplish your basic objective of preventing life insurance policies from becoming too investment-oriented. The proposal would have the effect of preventing needed innovation in product design that can benefit the consumer.

We wonder if some insurers which support the suggested change may do so more out of a desire to protect their existing book of business from replacement and their existing product design. We are concerned, too, that the suggested change could serve to drive business to other financial intermediaries.

We are equally confused by the lack of any apparent rationale for amending the annuity tax rules adopted in TEFRA. Treasury accepted them last year. What has happened in the interim to warrant a change now? We know of nothing.

We particularly see no reason for using IRA rules as the standard. They were designed for a product purchased with before tax money. That is not the case with nonqualified annuities.

We support retaining the existing TEFRA rules as being in the best interest of the consumers. Once again, this proposed change will drive our consumers into the hands of other financial intermediaries.

Finally, a word of comment on the overall rate adjustment, the 25-percent deduction. Once again, the concept is acceptable. However, the question is whether the overall tax burden is appropriate as proposed. We think it is not.

We appreciate this opportunity and we will be happy to answer your questions.

[The prepared statement follows:]

STATEMENT OF RAYMOND H. KIEFER, PRESIDENT, ALLSTATE LIFE INSURANCE CO.

Allstate Life Insurance Company welcomes the opportunity to present its views regarding the tax proposal developed by Congressmen Stark and Moore. We particularly appreciate the Chairman's invitation to testify.

In our May 13, 1983 statement to the Subcommittee on the general subject of life insurance company taxation, we made the central point that ultimate tax legislation must be fair to our policyholders, fair to the company and fair to the public. We believe that the "Stark-Moore" tax proposal provides a sound starting point for developing new permanent tax law for life insurers. With some adjustments and clarification we believe that proposal can meet the "fairness" criteria mentioned above.

A brief description of Allstate Life, its markets and its philosophy of operation will help place our specific comments in better perspective. Allstate Life is a relatively young company, 25 years old. We sell life insurance principally through the Allstate Insurance Company property/casualty agents. While we sell in most markets, our primary market is "middle America", the low and middle income family. In selling the lower income family, we are serving markets no longer served by many of the major life insurers. Our product portfolio is limited by comparison to most major life insurers. Last year our new business sales were term insurance, 44 percent by number of policies and 78 percent by face amount of insurance, while cash value type policies accounted for 56 percent by number and 22 percent by face amount.

For most of our history we were principally a writer of personal life insurance. While not forsaking our traditonal markets, we are now a "changing" company, changing to meet new times, new opportunities, new markets and new consumer wants and needs. We are engaged in aggressive growth in the group insurance markets. We are opening new distribution systems and developing new products to meet the insurance/savings needs of a changing public, a public which is responding to savings incentives provided by the economy and by federal policy. We are introducing interest sensitive products such as Universal Life, for sale to our markets.

Our basic goal continues, i.e., to provide our customers with a quality product at a fair price and to do so while providing our stockholders with a fair return on their investment.

We see ourselves as a consumer oriented company, one which has been innovative in developing new benefits for the consumer; in voluntarily adopting life insurance cost disclosure procedures and in making very competitively priced life insurance easily and conveniently available to the public.

A few examples demonstrate this point we:

1. Were the first, and only company today, to our knowledge, that permits a customer to switch from whole life to term insurance in the first policy year and apply all premiums paid on the whole life policy to the term policy;
2. Have, on many of our policies, a provision that waives the premium due for 6 months, if the insured has been unemployed for at least 4 weeks;
3. Were the first company to voluntarily give a 10-day free look with cost disclosure information to all our new customers;
4. Have equalized agent's compensation between term and permanent forms of insurance to make certain the selection of plan meets the customer's needs;

This background should help make our tax history and our comments more understandable. Our comments will treat first the requests of the Subcommittee and then those major items in the proposal which are of concern to Allstate.

DIRECT IMPACT ON ALLSTATE LIFE

Income Tax Liability.—The proposal as presently drafted would increase our future tax liability dramatically and drastically. As Appendix A demonstrates, the same basic effect is produced for past years. Had this proposal been in effect for the years 1978 through 1982, our aggregate tax liability would have been 2½ times our actual taxes for those years. This extra tax of more than $70 million dollars would have reduced our December 31, 1982 surplus by 26 percent. 1984 taxes under this proposal are estimated to be $12.6 million dollars.

Competitive Position.—It is difficult to quantify the exact impact of the proposal on our competitive position. But looking at the subject in a broader context we can come to some general conclusions.

As to competition within the life insurance industry, the tax increase for stock companies is much more severe than that for mutuals, whether you compare with the tax produced under TEFRA or that under the 1959 Act. In addition, segment balance has not been achieved by the current formulation of the proposal. The Treasury's estimate of a 53/47 split between mutuals and stocks respectively for 1984 is seven (7) percentage points lower than what we believe is an appropriate segment balance (60/40), measured by asset shares. This tax disparity obviously will disadvantage the stock companies, and Allstate, in the marketplace.

More specifically, the drastic tax increase for Allstate means that we would have to increase premiums if we are to retain our current return on equity. The bulk of our existing policies have guaranteed premiums and benefits—we cannot increase premiums on those policies. In today's environment we cannot lower our costs on those policies. Mutual companies, on the other hand, could assess the additional tax cost to old policies through the dividend process. On new policies they can assess the increased tax either by increasing premiums, reducing future dividends or both. Since the level of tax increase on mutuals is less than stocks, they will be in a superior competitive position.

As respects competition with other financial intermediaries, whose taxes are not being increased, we will suffer serious new competitive disadvantages. We comment further on this under "Overall Rate Adjustment".

To maintain present levels of return on equity, we would have to raise premiums by about 5 percent on both new and old policies. However, as previously noted, we cannot raise premiums on existing personal life policies, since we issue only guaranteed cost products. We would be restrained by mutual company competition in trying to recoup the additional tax on old business by raising premiums on new business beyond the 5 percent increase on such premiums dictated by this proposal. Therefore, we would have to absorb those tax increases. That, in turn, would reduce our ROE, restrain future growth and expansion plans and adversely affect our attractiveness to our stockholder as an investment. All of this adds to our inability to compete and becomes part of a vicious circle.

We must not forget that increased prices will mean reduced amounts of protection for the consumer per dollar of premium. (The reduction in amounts of protection will be greater for term insurance.) And it will mean reduced levels of cash values. Reduced insurance protection works contrary to societal needs, recognizing that the average amount of insurance in force per family is about two years earnings. The combined effect of reduced cash values and increased premiums on personal life insurance—especially term insurance—will, in our opinion, decrease the total amount of life insurance which would otherwise be sold.

SEGMENT BALANCE

As stated earlier, we believe that the relative tax burden should be related to the asset shares of the mutual/stock segments of industry. After all, assets are the wealth producing element. On that basis, segment balance at this point should be 60 percent for mutuals, 40 percent for stocks. That segment balance will produce a "neutral" tax bill, one which will not create an artificial competitive edge. That is a principle inherent in the 1959 Act and the method by which segment balance was determined prior to TEFRA. Returning to a 60/40 segment balance will restore competition to a fair basis.

OVERALL RATE ADJUSTMENT CHANGES

Other committees of Congress and the Treasury are expending considerable energy studying the new financial services market, of which life insurance is a part, with the objective of creating a level playing field between the various providers of financial services. That playing field will be heavily titled against life insurers if tax law serves to put life insurers at a competitive disadvantage. As we pointed out in our May 13, 1983 statement to the Subcommittee, life insurers are already at a competitive disadvantage to the banking and thrift industry. According to the 1982 Annual Report of the Minneapolis Federal Reserve Banks, between 1959 and the end of 1981 bank and thrift shares of the financial asset market held relatively steady at about 60%, while insurer shares of that market dropped from 24.7 percent to 16.9 percent. The General Accounting Office Report of September 18, 1981 (covering the years 1960–1976 indicates that, as a percentage of assets, life insurers have since 1965 paid more in taxes than banks. The average tax in terms of percentages of assets for the years 1970–76 was about .65 percent for insurers and .15 percent for banks. From 1972 to 1976 life insurers paid more taxes in absolute dollars than did the banks. From 1959 to 1979, life insurers share of total corporate tax revenues went from 2.5 percent to 4.2 percent, again a clear indication that life insurers are currently not undertaxed.

The current proposal, according to Treasury estimates, will produce approximately $4 billion plus in total tax revenues for tax year 1983. That is said by Treasury to be about what would be produced by the 1959 Act, were it to be applied unchanged by TEFRA (absent Mod-co). However, industry's best current estimates are that the 1959 Act (without Mod-co.) would produce about $3.3 billion dollars in taxes. The current proposal is thus about $1 billion dollars more than would be produced by the 1959 Act. And, we must point out, that our estimates of the 1959 Tax Act revenues is $1 billion dollars higher than produced under TEFRA. As a result, the current proposal raises tax revenues by $2 billion dollars from current levels.

In effect then, the current proposal reverses TEFRA's designed tax reduction and singles out the life insurance industry for disparate treatment compared to our industries. Non-insurance corporations received tax reductions of various sorts just prior to the passage of TEFRA, reductions which did not benefit the life insurance industry. TEFRA was designed to afford the life industry some tax relief compared to the 1959 Act, after removing Mod-coreinsurance. To suggest that pre-TEFRA tax levels are now the appropriate levels discriminates grossly against life insurers and aggravates an already bad competitive situation in relation to others in the financial services marketplace. Personal life insurance premium's share of the consumer's disposable dollar has decreased from 2.7 percent in 1966 to 1.8 percent in 1981, reflecting our loss of competitive position relative to other financial institutions.

We believe we should bear our fair share of taxes. However, a fair share is not achieved though the use of a 25 percent deduction. Equity would require a percentage close to 40 percent, if no other charges were made.

COMMENTS ON OTHER SECTIONS OF THE PROPOSAL

As a preface to these comments, we would like to express our total support for the positions enunciated by the representatives of the Stock Company Information Group at these hearings. A number of these issues are of such great importance as to deserve special comment by us.

Reserve Deductions.—In its efforts to resolve perceived problems with the provisions of the 1959 Act, the drafters have pushed the pendulum too far in the other direction. In addition, they have paid too little attention to fundamental concerns affecting both the consumer and the company.

One of these concerns is the potential impact minimum statutory reserves, as a tax base, can have on solvency of companies, particularly small companies. There is little market incentive to using reserves that fit your market and operating methods when tax policy gives a company no credit for reserves established in excess of the minimums. The increased potential for insolvency, while almost impossible to quantify, redounds to the detriment of the consumer and ultimately to other insurers which may have to pay for the costs of such insolvencies through state insurance guaranty associations.

The second and very important concern arises out of the fact that companies factor their future tax liability into the price of their products. As previously stated, stock companies issuing guaranteed cost products cannot change the cost of those policies already on the books. Applying the new standard to existing policies will detract substantially from the profitability of those products, as well as markedly increasing future tax liabilities. For example, our taxable income would be increased about substantially over the next 10 years under this proposal just by reason of additional reserves flowing into income.

As specified in the proposal, any new reserve requirement should apply to all in force policies as well as to policies issued on and after a specified date. However, the change from the old reserve basis to the new basis (effective January 1, 1984, referred to as the reserve overhang) should be ignored. There should be no requirement that it be brought into income over the next 10 years.

We believe there is ample justification both in general tax principles and in fairness between segments of the industry in not bringing this reserve overhang into income. Mutual companies would not effectively be taxes on most of these reserve releases, as they are fed back into income over 10 years.

Furthermore, our personal life products—and those most stock companies—were priced based on the tax laws in effect at the time they were issued. We relied on provisions of the law which gave special deductions for non par policies which are now being eliminated. These products have a premium guaranteed for the life of the contract. As mentioned earlier, we cannot change the premium. In general, our prices are considerably lower than comparable plans sold by mutuals because our policies contain no provisions for dividends. We have no mechanism to pass this tax on to our customers, even if we wanted to.

There is also precedent for prospective application of tax law when there is radical change—and this proposal meets that test, as the increased income tax figures clearly demonstrate. Such precedents can be found in the 1969 change in the reserving techniques of banks and thrifts as well as in the 1976 and 1982 deferral limitations for domestic international sales corporations.

Equity, therefore, justifies ignoring the reserve overhang in the tax calculation.

Ownership Differential.—We applaud the concept set forth in the propsal. Without this concept there can be no fair tax law. We do, however, urge the Subcommittee to again consider the suggestions of the Stock Company Information group, both as to additional items to be included in calculating surplus for the purposes of this deduction as well as a more appropriate rate of return.

In particular, a limitation on reinsurance when calculating surplus should be reinserted in order to prevent circumvention of the intent of this provision. As we pointed out earlier, segment balance between stocks and mutuals has yet to be achieved. The limitation on deductibility of dividends is the appropriate way to accomplish that segment balance.

Stock Subsidiaries of Mutual Life Companies.—Again we applaud the concept set forth in the proposal. Such an approach is absolutely necessary to not only preserve the total tax base for revenue purposes but also to preserve fairness between segments of the industry and segment balance. We would suggest, however, that 51 percent is a more appropriate control measure than 80 percent. It will help prevent evasion of the intent of this measure. (The Subcommittee should be aware of the possibility of joint ventures between mutual companies or partial ownership by other investors, such as pension plans, as a means of circumventing this 80 percent requirement).

Phase III Account.—Four options are held forth for Subcommittee attention. Some would force portions of the account into income over a period of time. We believe that such a provision is essentially punitive. It does not take into consideration the impact of such action on an insurer's solvency nor upon the stock values of the insurer in the hands of small investors.

Of the options offered, the fourth—continuation of the existing treatment—is the only acceptable one. However, before any decision is made the Subcommittee should consider a fifth option, i.e. not taking any portion of the account into income. There is considerable justification for such action when one considers that mutual companies were not subjected to tax on underwriting gain under the 1959 Act. (The Phase III account was in part an offset for stocks). That underwriting gain went into surplus of mutuals and will escape tax. That fact, in particular, is justification enough for rejecting other enumerated options. Furthermore, as mentioned in our comments on "Reserves", established tax principles dictate this fifth option of starting fresh when there is a major revision in the tax law. May we also point out that TEFRA allowed forgiveness of the tax savings derived from certain Mod.-co. arrangements, considered to be a tax abuse. That "forgiveness" benefitted mutual companies primarily.

Individual Taxation.—This portion of the proposal needs very careful consideration by the Subcommittee. The decisions made could substantially interfere with the ability of the life insurance industry to compete in the new financial services marketplace. They could, in fact, be anti-consumer in their effect.

Definition of Life Insurance.—We support the concept of the establishment of guidelines to determine if a policy is to be afforded treatment as a life policy. We also support the concept of an alternative premium or cash value test. However, we must emphatically oppose the use of a 10 pay life guideline and the 250 percent of cash value test.

The proposed tests are really anti-consumer in their effect. They are designed not so much to prevent abuses but to protect blocks of existing life insurance business in the hands of insurers from replacement by the writers of interest sensitive products, such as universal life policies. For years, the life insurance industry, and stock insurers in particular, was criticized alleging policyholders were not receiving appropriate interest earning on accumulated cash values. Much of that criticism originated with a federal agency, the FTC. It would be ironic indeed that the Federal government should now prevent the life insurance industry from bringing such consumer oriented products to the public in a way that can increase returns on existing policies, i.e. by replacement of older policies with new interest sensitive products. Both the 10 pay life rule and the 250 percent rule will have that effect.

Those insurers which advocate the proposed rules do so out of self interest and with a certain tunnel vision. They apparently fail to see that such rules will serve only to force accumulated cash values in the hands of other financial intermediaries. That, in turn, will aggravate our industry's loss of asset market share and worsen an already bad situation. It will also deprive the consumer of product choice, if the consumer wishes to realize a better return on accumulated cash values.

When you look at this subject of interest sensitive products, the Subcommittee must realize this is not just a "rich man's game". The people in Allstate's market, "middle America", are interested in life insurance products like universal life. Our research demonstrates that. We are in the process of bringing such products to our market. Adoption of the 10 pay life and 250 percent rule will substantially detract from our ability to serve the wants of our consumer. It will inhibit product innovation to meet today's and future markets.

We respectfully suggest that there is a total absence of evidence of any need for a change from the guidelines established in TEFRA for universal life. The TEFRA guidelines should be extended to all life insurance policies. We submit that the proposed tests have no sound basis in tax policy or in insurance. Worse yet, they are a rank form of protectionism and are anticonsumer in their impact. Furthermore, the proposed change has little effect on tax revenues.

Annuities.—Here, too, we are confounded by the proposed changes from the rules accepted by the Treasury and adopted by the Congress under TEFRA. Those rules were accepted as sufficient to remedy any demonstrated abuses. We see nothing in the interim to demonstrate any need for a change in the rules, much less for a change to those proposed. In addition, the implied analogy to IRA's is misplaced. The IRA rules may be justified by the fact that pre-tax dollars are used to fund the account. There is no similar justification with respect to annuities purchased with after-tax dollars. We suggest that the existing rules in TEFRA are sufficient to prevent abuse and should be retained.

This concludes our statement. Our failure to comment on other portions of the proposal should not be taken as disinterest, or a non-impact on Allstate Life. That is not the case. We simply do not have anything special to contribute beyond the comments of the Stock Company Information Group, whose views we support.

APPENDIX A.—ALLSTATE LIFE INSURANCE CO. IMPACT OF STARK/MOORE PROPOSED FIT LAW

Year	FIT amount in millions		FIT as a percentage of assets EOY	
	As filed	S/M proposal[1]	As filed	S/M proposal
1978	$9.0	$23.1	1.0	2.5
1979	13.6	24.7	1.3	2.4
1980	22.0	38.9	1.9	3.3
1981	.7	18.2	Nil	1.3
1982	[1] 2.9	16.1	.2	1.0
5 years	48.2	121.0	.8	2.0
1984	[1]0	12.6	0	.7

[1] Estimated.

Note: 1978–82 numbers assume the proposal became effective January 1, 1978; 1984 number assumes the proposal becomes effective January 1, 1984.

Chairman STARK. Thank you very much.

Why don't we recess for 10 minutes and everbody should be back from the vote. The committee will stand in recess until 2:45.

[Recess.]

Mr. JENKINS [presiding]. Because of the time restraints, we will continue, although some of the members are still over on the House floor voting. They will be coming back in during your testimony. I believe that Mr. Richards was just beginning to testify.

STATEMENT OF ALAN RICHARDS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, E. F. HUTTON LIFE INSURANCE CO.

Mr. RICHARDS. Thank you.

Mr. Chairman and members of the subcommittee, I am Alan Richards, president and chief executive officer of E. F. Hutton Life Insurance Co.

I am appearing today on behalf of my company. E. F. Hutton Life and I have with me Mr. Jeffrey Hahn, vice president of our company and Mr. Lynn Miller, vice president and actuary.

First, let me say that the proposal before the committee represents a sound, basic structure for a permanent tax law. We fully support the statements made by Messrs. Lebed and Rolland on behalf of the Stock Information Group.

The most important aspect to the proposal from our standpoint relates to the definition of life insurance. As I pointed out during my previous appearance before this committee, we have a paramount interest in the subject, because we originated universal life and it now comprises almost all of our new business.

You have asked me to provide specific data on the effect of the Stark-Moore proposal on our company. Before I do that, though, I would like to depart from the remarks that I prepared to respond to a comment that was made a short while ago to the effect that "universal life is nothing more than an investment contract with a thin veneer of life insurance."

Nothing could be further from the truth. The late, great parliamentarian, Sir Winston Churchill, seeking to avoid directly accusing a fellow Member of Parliament of a falsehood, invented the term, "terminological inexactitude." I submit to you that the idea that universal life is an investment contract with a thin veneer of life insurance is a terminological inexactitude. Under current law, universal life is required to have a larger death benefit in relation to the cash value in the early policy years than is allowed for conventional life insurance policies.

The life insurance industry is probably the major source of long-term capital available to the economy of the United States. Its ability to continue this role depends on our being able to offer and develop products which are responsive to the needs of consumers.

It is of overriding importance that our business not be locked into a rigid product mode, a mode which, incidentally, has resulted in a continuous erosion of our competitive position for many years vis-a-vis other financial intermediaries.

A sound definition for both universal life and products yet to be developed is required in our industry for both stocks and mutuals—we should keep in mind that several mutuals now offer universal life including one or two rather large ones—if our industry is to remain competitive in the eighties and beyond.

While we applaud the committee's proposal to adopt a definition covering all life insurance policies, in our view, the proposed definition will severely inhibit future product development.

Under current law, there are alternative tests: The guideline premium test and the cash value test.

The guideline premium test in turn consists of two parts. The first part limits the amount of premiums which can be paid. And I might digress here to tell you that in terms of the limitation of the amount of premium that can be paid, this has been a very effective test, a very effective addition to the law, a very effective way of insuring that universal life is not sold as an investment contract.

There is no better measure of the investment component of any life insurance policy than the size of the premium per thousand of insurance.

Our own experience shows, for instance, that at age 35, we are limited to $15 of annual premium per $1,000 of insurance. We actually only get, on the average, somewhere around $9 per $1,000.

On the other hand, the average premium for the 25 largest mutuals last year was approximately $22 per thousand.

As I said, the guideline premium test consists of two parts. The first part limits the amount of premiums. The second part sets a minimum level of death benefits in relation to the cash value which is expressed as a corridor percentage. The corridor is the total death benefit less the cash value.

The proposal further restricts the amount of premium which may be paid and increases the amount of risk we would be required to assume under a substantially enlarged corridor. All, I might add, to the detriment of the consumer.

We believe the committee should focus on the fundamental purpose of these tests. Is the purpose to force all life insurance policies into the traditional mode, or is the purpose to restrict the use of life insurance policies as investment vehicles?

The legislative history of section 101(f) indicates that the purpose was, indeed, to prevent excessive investment-oriented policies. We believe this concern was proper.

The current proposal goes far beyond the need to prevent excessively investment-oriented policies. The effect of the proposal is to act as a barrier to competition both within the life insurance business and with other financial intermediaries.

Experience has shown that the concepts contained in the existing law satisfy this concern. Under the current proposals consumers who wish to upgrade their existing policies to more modern and economically efficient forms of life insurance will be prevented from so doing under the new proposal.

This barrier will exist whether the exchange takes place within their present company or with another company. This anticonsumer result is caused by the 10-payment life test, which unduly restricts the amount of premiums which can be paid in early years.

This effectively prohibits consumers who owned existing long-duration policies or, for that matter, medium-duration policies from exchanging those policies with their outmoded interest and mortality assumptions for modern forms of insurance.

The size of the corridor also works to the detriment of the consumer. The corridor was established as part of a tradeoff between the guideline premium test and the cash value test. Under the guideline premium test, the restrictions on the amount of premium that can be paid, results in a much larger death benefit in relation to the cash value in the early policy years when compared with the alternative cash value test.

The tradeoff is that in later years, the amount of risk that must be provided under the guideline premium test can be less than that required under the alternative test. The guideline premium test prevents undue investment emphasis by limiting the amount of premium which can be paid.

There is no such limit under the cash value test. It must be noted that the corridors under the guideline premium tests become a factor only if there is prolonged high inflation.

For example, under current law, a policy issued to a male age 35 with the payment of a maximum premium at issue—guideline single premium—will take over 17 years to reach a "corridor status" assuming an 11-percent cash value interest rate.

Although the cash accumulated under the contract will seem large by current standards, when adjusted for inflation, the consumer is, in effect, barely holding his own. By utilizing a higher corridor, the consumer's cash values have been utilized to purchase risk coverage the consumer may not either want or need.

If I could illustrate this by describing the ratio in the proposal as a numerator and denominator, the numerator is the amount of insurance. The denominator is composed of two portions, the net contributions to the cash value and the accumulated interest on the cash value.

The accumulated interest is subject solely to market forces and is beyond the control of the issuing company. Obviously, the higher the denominator is raised, the larger the numerator must be raised, and in inflationary times, that numerator would be raised very high and probably beyond the needs of the consumer.

To take an extreme example, if we were in Brazil, the amount of insurance that would be required in the numerator would be an almost infinite amount because the ratio has to be kept the same and the denominator is increased by an enormous amount.

So much for universal life. On the other policyholder tax issues, we strongly support the positions expressed by representatives of the Stock Company Information Group.

Finally, you have asked for the revenue effect on our company of the committee proposal. Under existing law and after adjusting for reinsurance transactions as was requested, Hutton Life incurred no tax liability in 1982, and under present law, would expect a similar result in 1983 and 1984.

This is because we are experiencing extremely rapid growth. As the committee knows, it costs more than a dollar's worth of expense to put a dollar's worth of business on the books, but, of course, in future years, when the kind of explosive growth we have been experiencing inevitably slows, those large amounts of new business would, under the old law, have ultimately generated significant taxable income.

At the moment, under the old law, our taxes would be zero. However, under Stark-Moore, our 1984 tax liability would increase from zero to an estimated $1.5 million.

If the modifications suggested by the Stock Information Group are adopted, and we support those modifications, the corresponding amount would be approximately $600,000.

Obviously, one would expect these amounts to increase in later years by substantial amounts to match our growth.

Nevertheless, we believe the structure of Stark-Moore provides a good foundation for a permanent solution.

Mr. **Jenkins**. Thank you.

[The prepared statement follows:]

STATEMENT OF ALAN RICHARDS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, E. F. HUTTON LIFE INSURANCE CO.

Mr. Chairman and Members of the Subcommittee, I am Alan Richards, President and Chief Executive Officer of E. F. Hutton Life Insurance Company. I am appearing here today on behalf of my company. Hutton Life is engaged primarily in the sale of individual life insurance policies and annuity contracts. The company is licensed to do business in 49 states and the District of Columbia.

I wish to thank the Chairman and the Members of this Subcommittee for inviting me to testify. Before going to the substance of my remarks, I wish to state that Hutton Life fully supports the positions taken by the Stock Company Information Group.

In my invitation to testify I was requested to direct my remarks to the specific impact of the Stark-Moore Proposal on Hutton Life. As the Subcommittee knows, the proposal is divided into two segments. The first segment deals with company taxation. The second segment deals with policyholder taxation. The bulk of my presentation deals with the second segment. The second segment is critical because it is this segment which will determine Hutton Life's ability to actively compete and prosper in the increasingly competitive financial services industry. No matter how fair and equitable the corporate tax may be, unless we are able to offer the consumer a competitive product, we will not be able to prosper.

The primary focus of my remarks will be on the definition of life insurance and how it impacts the relatively new form of life insurance known as "Universal Life." Hutton Life originated Universal Life in 1978. We have been one of the leading companies offering this significant innovation to the consumer. The effect of the proposal will be to unnecessarily eliminate many of the benefits this policy offers consumers.

I have previously testified before this Subcommittee. I will not repeat my written statement which I filed with the Subcommittee prior to the May hearings, nor will I repeat the testimony which I gave to the Subcommittee on May 11, 1983.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added Section 101(f) to the Internal Revenue Code. This section adopted alternative tests to determine when a flexible premium life insurance policy will be treated as a cash value life insurance policy for federal tax purposes. These tests, contained in Section 101(f), are sound. Except for technical amendments to eliminate unintended potential consequences, Section 101(f) should be made permanent.

A discussion of the logic behind the alternative tests in Section 101(f) is in order.

The first test is the "guideline premium test." This is a two part test. In order to qualify as life insurance, the policy must satisfy both parts of the test.

The first part of the test restricts the amount of premiums that can be paid into the policy and hence the degree of "investment" content. The "guideline premium" limitation is computed as the greater of the guideline single premium (which limits early premiums) or the sum of the guideline level premiums.

The strength of this portion of the test comes from the methods and factors prescribed for computing the guideline premiums: the mortality, interest and expense assumptions, on one hand, and the policy benefits permitted to be valued and prefunded, on the other. The proposed definition uses at least 6 percent interest for the guideline single premium, and at least 4 percent for guideline level premiums. A higher interest rate results in a lower premium. The test does not allow prefunding of any increase in the amount at risk.

The second part of the test limits the amount of cash value which may accumulate (per $1,000 of death benefit) under the policy. The limitation is necessary because, in times of high interest rates, the cash values can increase to a point where the net amount of risk becomes smaller and could ultimately disappear. The test prescribes a "corridor"—a minimum amount of "pure" insurance which must be maintained at all times.

The second test is the cash value test. The cash value test is a one part test. The cash value test limits the cash value that can be accumulated under the policy. To meet this test, the policy must ensure that the cash value may not at any time exceed the net single premium for permitted policy benefits.

A policy can qualify under either test. If a policy fails to qualify under either test it will NOT be treated as an integrated life insurance contract but rather as a combination of term life insurance with an annuity or deposit fund (depending on the terms of the policy).

The purpose of the alternative tests was to permit Universal Life to compete on an equal footing with traditional life insurance policies. Although there are some differences, product balance is maintained. Under the guideline premium test lower cash values are required in early years compared to the cash value test. The converse is true in later years. This early year difference is the result of a higher interest rate (6%) used in calculating the guideline single premium compared to the interest rate that can be used in the cash value test. In later years, the difference is due to a smaller "corridor" under the premium test compared to the "corridor" required under the cash value test.

The legislative history of Section 101(f) indicates that "Congress was concerned by the fact that some flexible premium contracts can be overly investment oriented by allowing large cash value buildings without requiring a continued reasonable amount of pure insurance protection. In the case of such contracts, the traditional use of life insurance as financial protection against early death could be overshadowed by the use of the contract as a vehicle for tax favored investment."

The guideline premium test, enacted under TEFRA, was not intended to allow easy circumvention so that the minimum risk corridor could be reached in early durations. The computational rules were developed to prevent such use. The computational rules provide the strength to the test.

In our view, the guideline premium test adequately responds to the government's concern about excessively investment oriented life insurance policies. In fact, under the cash value test a higher amount of premium can be paid per unit of death benefit than under the guideline premiums. An individual seeking to use a Universal Life policy as a heavy investment contract will find the limitations contained in the guideline premium test prohibitively restrictive.

In developing comprehensive tests to define what is life insurance for federal tax purposes, the concern of the Subcommittee should be twofold. First, the intent of TEFRA to prevent excessively investment oriented policies should be continued. A second concern, which is by no means incompatible with the first, is to permit maximum design flexibility for life insurance policies. Flexibility is needed to enable life companies to compete in the 80's and beyond.

Some have suggested that the "traditional" life insurance test should be mandatory for all policies. This traditional test is the so-called "cash value" test. We believe such a position does not address the fundamental concern. The fundamental concern is not whether life insurance companies should be forced to remain in the traditional mode—a mode in which life insurance companies are losing market share to other financial institutions—but rather whether life insurance policies are being used for life insurance purposes and not as disguised investment vehicles. In our view, the guideline premium test in the current law satisfies this requirement.

The effect of forcing Universal Life companies to adopt the cash value test is not merely confined to making Universal Life the same as a participating Whole Life policy with paid-up additions. The problem for Universal Life insurance is really much worse.

If Universal Life is subject only to the cash value test, the crediting of excess interest during a period when the cash value is limited by the test would result in an immediate increase in the death benefit. This produces the same result as requiring excess interest to purchase additional paid-up insurance and is somewhat analogous to dividends purchasing paidup insurance under a participating policy. However, there is a significant economic difference in the basis used in a Universal Life policy compared to a participating policy. Under a participating policy, paid-up additions can be and are issued using rather conservative actuarial assumptions. Conservatism is necessary, since the policyowner is not required to furnish evidence of good health to obtain these additional amounts of insurance. With Universal Life, the actuarial basis used for determining "paid-up additions" uses the same basis underlying the value of the basic benefit structure of the policy. This is because the cash value supporting paid-up additions under Universal Life will continue to be based on current excess interest credits and current mortality charges which will in turn purchase additional insurance.

With most participating contracts, the so-called excess interest credits on cash values supporting paid-up additions is based on a significantly lower (more conservative) interest assumption. In fact, it is common knowledge that most companies selling participating business view paid-up additions as contributing a significant source of earnings due to the conservative interest and mortality assumptions underlying the determination of these additions. It would be unfortunate if the cash value test were to result in a more conservative, less consumer oriented approach for Universal Life which would be necessary to protect the company against higher mortality risks. The premium guideline test does result in additional insurance amounts when a policy is in a "corridor situation" and excess interest is credited. But the amount of such additional insurance is a manageable and acceptable risk for the company due to the smaller corridor percentages that exist when compared to the cash value test "corridors."

A much more serious problem associated with the cash value test occurs when the policyowner makes a premium payment during a period when the cash value is limited by the test. This is because the payment of a premium will result in an immediate increase in the death benefit. Thus, a policyowner in very poor health could increase insurance coverage merely by making a premium payment. The company's only recourse would be to restrict premium payments or institute the expensive procedure of requiring evidence of good health. This does not occur with a participating policy.

Unfortunately, this approach of restricting reasonable levels of premium payments would inject considerable uncertainty into the sale of Universal Life. At the time of issue, under the premium guideline test, the policyowner knows for certain how much premium can be paid. Under the cash value test it would be virtually impossible to illustrate with confidence any pattern of reasonable premium payments. One of the most important consumer features of the product—the flexibility of premium payments—would be obliterated, to the detriment of the consumer, thus making it extremely difficult to market the product.

Life insurance is purchased because of the stability it provides. Each element of uncertainty, especially tax-related uncertainty, puts Universal Life at a disadvantage to other cash value policies. Whole life, including participating whole life, with its fixed premiums, its time honored dividend scales, and its predictable (and actuarially conservative) paid-up additions would be portrayed as being much more certain than Universal Life.

It has been suggested that increasing the "corridor" in the guideline premium test is appropriate. We do not believe this is a desirable course of action. The very problem with the cash value test is its potential for requiring excessive increases in death benefits. An enlarged "corridor" would create the same difficulty. If, as in the proposal, the corridor is excessive, Universal Life would suffer the same competitive disadvantage as under the cash value test.

As previously noted, the guideline premium test, including its "corridor" component, was framed as a "trade-off." The guideline premium test permits less premium than is permitted by the cash value test. In return for the lower premium, the consumer is not penalized because of the crediting of excess interest.

The amount of excess interest credited cannot be determined at the time of issue. If the "corridor" test is enlarged, to force a parallel with the cash value test, the result would be that less premium would be accepted under the guideline premium test than under the cash value test even though the risk assumed by the company would be the same. This would be both pointless and unfair.

The source and purpose of excess interest should also be kept in mind. Excess interest is the result of an inflationary economy. It's occurrence is outside the control of the consumer. Excess interest is credited to insurance so that the consumer does not suffer a loss in terms of real policy cash value. The impact of an excessive "corridor" is to deprive the consumer of some of the cash value on which he would be "breaking even" in constant dollar terms, by forcing the purchase of additional risk coverage which may not be needed or wanted.

From the foregoing general discussion on Sec. 101(f) and the logic behind the alternative tests I would like to comment specifically on the guideline premium test contained in the Stark-Moore proposal. In our view the proposed modifications are both unnecessary and anti-consumer.

The proposed guideline premium test establishes a ten pay premium standard as the guideline premium. The test also establishes a corridor of 250 percent for attained age forty or less grading down at four percent per year until a corridor of 110 percent is attained at which point the corridor level off. No justification has been offered to justify the change. To our knowledge there are no marketing abuses associated with the current guidelines. After one year of study those companies which do not want to compete with modern policies have been able to develop only one highly theoretical potential "abuse" and it turns out to be a matter easily corrected by amendment to the current statute.

The ten pay rule is anti-consumer. It unduly restricts the amount of premiums which can be paid in early years. This effectively prohibits consumers from updating their life insurance coverage by preventing them from exchanging the existing policies which have high cash values for more modern and economically efficient policies.

Although the ten pay rule results in a much lower investment element during the first two or three years of the contract, this restriction rapidly wears off and by the tenth year the ten pay rule produces about the same cash value as the current rules. In other words, very little has been accomplished in restricting the investment nature of the product, but the consumer will be adversely affected.

The proposed corridor is also anti-consumer. As previously noted the corridor only comes into play if there is continued high inflation. A consumer who purchases a policy for only the "right" reasons may be penalized because of inflation—a factor totally outside of his or her control—by forcing the purchase of additional insurance which may not be needed nor wanted. The purchase of additional insurance should be a decision voluntarily made by the consumer, it should not be automatically imposed by the inflation rate.

Although we do not market our policies on the basis of the deductibility of policy loan interest and do not have many policies in force which would violate the proposed limitation on deductibility, we do not believe that the proposed limitation is justified. Just as consumers are able to borrow on the increased value of their homes without limitation, we believe that they should be able to borrow against the policy's cash value.

We were very surprised to see suggested changes in the annuity distribution rules. Permanent changes in the tax treatment of annuity contracts were made in TEFRA. It is our understanding that the changes have worked as expected and that the Treasury is satisfied with the result.

If Congress decides that some change is warranted, we think the adoption of the IRA distribution rules is too harsh. IRAs and annuities are different. The reason for the IRA rules is that all contributions to the IRA are tax deductible. The same is not true for annuities. This alone should mandate a more liberal rule.

When permanent changes are enacted into law the public has the right to rely on the changes. Many annuities were sold on the basis that TEFRA was permanent. Now a new set of rules is being proposed for no apparent purpose. One of the hallmarks of our industry is permanence. Given the scope of changes in taxation mandated by both the interpretations of the Internal Revenue Service and statutory changes enacted by Congress, consumers are beginning to ask whether Congress will really let them keep what they think they are buying. In absence of some demonstrated abuse, we strongly recommend that there be no additional changes in the law.

The final proposed change in the policyowner tax issue is the change in the basis rules. The proposal does not purport to have a revenue impact. There is no abuse associated with the present rule. The only known justification is that the proposed change conforms to someone's notion of "symmetry" in the tax law. Moreover, the proposed change does not recognize that a whole life contract is indivisible in nature and should not be fragmented into various pieces.

Although there may be an argument for "symmetry" in the Internal Revenue Code, since the proposed change will not raise additional revenue, we believe that it is appropriate to suggest that Congress examine the cost to the industry if the proposal is adopted. Industry costs will be high. We will undoubtedly be required to keep track of the necessary information for the duration of the contract—a period which might easily exceed 50 years. Forms will have to be sent to the policyowner and the government when the contract is surrendered. The cost of compliance will undoubtedly exceed the revenue generated. Thus, we believe the proposal is inadvisable.

We have protected the amount of tax E. F. Hutton Life Insurance Company would pay under existing law (TEFRA) and the Stark-Moore proposal. As requested, the tax has been computed assuming that no reinsurance transactions were in effect.

Numerous assumptions and estimates were required to compile these numbers. However, they were applied consistently among the proposals and represent management's best estimate of future operating results.

The most critical assumption made was that the policyholder taxation rules proposed by Stark-Moore would not be enacted. Otherwise, we believe that our sales projections would be too optimistic.

The following table compares the tax to be paid under two different assumptions:

	Tax paid 1984	Cumulative tax paid 1982–86
TEFRA	0	0
Stark-Moore Proposal	$1,553,000	$12,685,000

Mr. JENKINS. Mr. Hipp, we will be delighted to hear from you.

I apologize if I have to rush some of the people along, but we would like to complete our hearings this afternoon.

Mr. Hipp, we are delighted to have you up from South Carolina to visit with us.

STATEMENT OF W. HAYNE HIPP, CHAIRMAN OF THE BOARD, LIBERTY LIFE INSURANCE CO.

Mr. HIPP. Thank you, Mr. Chairman and members of the committee.

My name is Hayne Hipp. I am chairman of the Liberty Life Insurance Co. of Greenville, S.C. I appreciate this opportunity to appear before you today to comment on your proposal and its impact on our company.

I believe that this proposal provides a very viable framework for developing a permanent tax solution for all parties involved.

I would also like to add our endorsement to the position outlined previously by Mr. Lebed and Mr. Rolland. In particular, I would like to express our strong support for the stock ownership differential concept in the Stark-Moore proposal.

To give you some background information, within the insurance industry Liberty Life is regarded as a small-to-medium sized company, with $600 million in assets and over a million policyholders. We market primarily life, group and mortgage redemption insurance.

While we have a traditional portfolio, we were one of the earliest marketers of universal life insurance. In 1982, universal life counted for 37 percent of our sales; and in the first half of 1983, 57 percent.

I would like to comment on the specific impact that the Stark-Moore proposal would have on Liberty Life's products, competitive position and tax liability.

First, on Liberty Life's historical tax liability. In each of the years 1979 to 1981, Liberty Life paid approximately $6 million a year in Federal income taxes. Increased sales, developmental expenses, and group losses caused our statutory earnings before taxes to drop 31 percent in 1982. These factors caused our tax phase to change, resulting in a substantial reduction in our 1982 taxes to $3.7 million.

The stopgap amendments had a negligible effect on our tax position, decreasing our 1982 taxes by about $100,000.

For 1983 and 1984, we are projecting no tax liability because of increased operating expenses, projected higher sales, and a large 818(c) adjustment resulting from these sales.

Now, what is the tax effect of the Stark-Moore proposal on Liberty Life? Had this proposal been effective for 1982, it would have increased our tax liability 2½ times from $3.7 million to $9.5 million.

Furthermore, under this proposal, our tax would increase to $8.6 million for 1983 and $9.4 million for 1984. This is substantially higher than our historical tax burden of approximately $6 million, and is an unreasonable increase which we would strongly oppose.

If we are to support this proposal, we would have to see two major areas changed. One relates to company tax liability—the deduction for life insurance reserves. The other relates to a competitive marketing environment—the section 101 guidelines for policyholders.

Turning to the first, we would be financially devastated if section 818(c) were to be repealed and minimum state law reserves were to be mandated without a "fresh start" rule.

Our actuaries have calculated that these proposed reserve changes would reduce our tax return reserves by $25 million because of the change to minimum State law reserves and by an additional $60 million because of the repeal of section 818(c).

This $85 million combined reserve deduction would increase our tax liability by $30 million over the next 10 years.

This $30 million additional tax, added to the other tax increases in this proposal, would be absolutely prohibitive for a company our size. It is, therefore, obvious that we could withstand the loss of future 818(c) benefits and the change to minimum State reserves only if we could get a "fresh start" as of the effective date of the new law.

Several reasons weigh in favor of a "fresh start" as a reasonable trade-off for the other tax increases which have been proposed. My written comments covered these in detail.

Let me summarize here by saying that the repeal of 818(c), without a fresh start, can lead only to a tax inequity among insurers; and that there is a strong precedent for a clean slate when there are such drastic changes in the tax law.

Our second major area of concern is the proposed section 101 guidelines, and their potential adverse effect on our policyholders. While we support the concept of a definition of life insurance such as provided by TEFRA, we would not agree that the proposed test is the correct one.

These proposed guidelines would greatly restrict the use of universal life and other flexible premium products for normal insurance purposes. Section 101 amendments should be designed to prevent only those abuses which have been clearly identified and should not unduly restrict the marketing of legitimate flexible premium and traditional life insurance products.

The proposal also lacks a guideline single premium limitation. This restricts existing policyholders from having the flexibility to move their insurance coverage and cash values to consumer oriented products. The guidelines should, therefore, be revised to include a single premium limitation to accommodate such policyholder-initiated rollovers.

The guidelines would also disqualify many of our traditional life insurance products, such as endowment at age 65. We have marketed most of these traditional products for 50 years or more. And they have been recognized even longer as basic products to meet specific insurance needs.

We believe that the TEFRA amendments to section 101 provided adequate guidelines for the qualification of universal life as life insurance. We are not aware of any reported abuses under these rules.

Insurance companies went to great expense modifying their policies and computer systems to assure continued section 101 qualification for our policyholders. The TEFRA guidelines should be left intact except to the extent necessary to correct any technical oversight and to extend them to other forms of insurance.

This subcommittee has done an outstanding job in building a framework in which to deal with this complex tax area. With the changes we have recommended, we can support this proposal.

However, not to urge changes in the "computation of the deduction for reserves" section and in the "definition of life insurance" section would be abdicating our responsibility to our stockholders and our policyholders.

Thank you for asking me to appear before you today. I look forward to working with you in finalizing a permanent tax package.

Mr. JENKINS. Thank you very much, Mr. Hipp.

[The prepared statement follows:]

STATEMENT OF W. HAYNE HIPP, CHAIRMAN OF THE BOARD, LIBERTY LIFE INSURANCE CO., GREENVILLE, S.C.

Mr. Chairman and members of the Subcommittee on Select Revenue Measures, my name is Hayne Hipp. I am Chairman of the Board of Liberty Life Insurance Company of Greenville, South Carolina.

I appreciate this opportunity to appear today before this Subcommittee to offer my Company's comments on the proposal put forth by Chairman Stark and Congressman Moore in the July 14, 1983, Committee Print. We believe that the proposal provides a useful framework around which to develop a permanent solution to the taxation of life insurance companies. Before proceeding to specific changes which our Company feels should be made to the proposal, we would like to add our endorsement to the position outlined previously by Mr. Lebed and Mr. Rolland. In particular, we would like to express our strong support for the ownership differential provision in the Stark-Moore proposal.

BACKGROUND INFORMATION

Within the life insurance industry, Liberty Life is regarded as a medium sized company, having $600 million in assets and over a million policyholders. In the 38 states in which we are licensed, Liberty Life is engaged primarily in the sale of life insurance, group insurance products, and mortgage redemption insurance.

While we have a traditional portfolio of products in the life insurance area, we were one of the earliest marketers of Universal Life Insurance. In 1982, Universal Life accounted for 37 percent of our non-group sales, and 57 percent for the first half of 1983.

HISTORICAL TAX POSITION

As for our tax position, Liberty Life has paid about $6 million in federal income taxes for each of the years 1979–1981. While our taxes have steadily increased through 1981, new business sales, product and agency development expenses, and losses from our group operations will combine to put us in a different tax phase and sharply reduce our taxable income for 1982 and 1983. As a result of these increased expenses and losses, our statutory 1982 earnings before taxes were down 31 percent from 1981.

Liberty Life was not involved in ModCo elections; and the other provisions of Stopgap amendments netted out to have very little effect on our tax position. We project that Stopgap decreased our 1982 taxes by $100,000.

TAX EFFECT OF STARK-MOORE PROPOSAL

Had this proposal been effective for 1982, it would have increased our 1982 tax liability well over 150 percent from $3.7 million to $9.3 million. For 1983 and 1984, we have projected no tax liability, whether under Stopgap or the 1959 Act. This is the result of increased operating expenses, projected higher sales of new insurance, and a large section 818(c) adjustment resulting from these sales. Under this proposal, our tax is expected to increase to $8.6 million for 1983 and $9.4 million for 1984.

NEED FOR "FRESH START"

Our first and major area of concern with this proposal is the absence of a "fresh start" rule for the reserves under the proposed revision. With such a rule, and with the modifications suggested below with respect to minimum State law reserves, our 1984 tax liability would be approximately $6.2 million as opposed to $9.4 million. Even though representing a tax increase for Liberty Life, we can live with this $6.2 million because it is in line with our historical tax burden. As a matter of information, our projected 1984 tax under this proposal is higher than our $6 million historical tax burden even though 1984 pretax income is expected to be down slightly from the 1979–81 level.

The Stark-Moore proposal would repeal section 818(c) and require the use of minimum State law reserves for tax purposes. It would further require that January 1, 1984, reserves for tax purposes be restated to this new basis with the difference brought into income pro-rata over the next ten years. Our actuaries have determined that the change to minimum State law reserves would reduce our beginning 1984 tax return reserves by $25 million. In addition, the loss of the section 818(c) election would reduce our beginning 1984 tax return reserves by an additional $60 million. The tax on this $85 million combine reserve reduction would be $30 million over the next 10 years.

This $30 million additional tax, added to the other tax increases in this proposal, would be absolutely prohibitive for a company our size. We must have a "fresh start" on reserves as of the effective date of the new law.

There are three primary reasons that weigh in favor of a "fresh start" as a reasonable trade-off for the other tax increases which have been proposed.

First, we have not obtained full tax benefit in all prior years for the reserve increases because we have been taxed in different tax phases over the years. In some years there was no benefit, in some there was only a half benefit, and in very few was there a full benefit. Adding these reserves to taxable income under a single phase system would lead to an inequitable result, not only for our company, but also for many other companies that have consistently been in a tax phase that resulted in little or no benefit for reserve increases.

Second, and somewhat related to the first, the Subcommittee is considering a life insurance company tax system radically different than the current one. The tax effect of any item of income or expenses under the existing three phase system could and often would be very different under this proposed single phase system. In view of the major changes being proposed in the computation of tax return reserves, a clean break with the old reserving system is appropriate. There is a strong precedent for this in the 1959 Act, which allowed companies to adjust to December 31, 1958, market value of investments in order to prevent taxation of capital gains which accrued under pre-1959 law.

Third, during those years when insurance companies were permitted to make the section 818(c) election there was no way that insurers could have anticipated its repeal. Nor was there any way that any company should have been expected to anticipate such a drastic change. Had we reason to expect repeal, Liberty Life, along with many other companies, may not have made the 818(c) election.

In addition, a fresh start is consistent with the treatment required by IRS regulation 1.810-2(c)(3) at the time of the initial 818(c) election. Under this regulation, the reserve adjustment to change the old basis to the new basis is simply not accounted for.

MINIMUM STATE LAW RESERVES

The Stark-Moore proposal would require the use of minimum state law reserves for tax purposes. Minimum state law reserves would be defined as full preliminary term reserves with the highest assumed interest rate and the most recent mortality table allowable under state law. We would favor the portion of the Stark-Moore proposal requiring the use of full preliminary term reserves. Our surplus is not high enough for us to use net level reserves for statutory purposes. If section 818(c) is to be repealed, we and many other companies without high surplus would be at a competitive disadvantage if larger companies with higher surplus were allowed to use statutory net level reserves for tax purposes.

However, we oppose any limitation on our company's choice of reserve mortality tables or interest rates. Since our actuaries would use mortality tables and interest rates which they consider appropriate to assure the company's continued solvency, the use of legislatively prescribed mortality tables and interest rates for tax purposes would require separate reserve computations. This would require prohibitively expensive systems changes to properly compute the tax basis reserves and apply a secondary cash value test.

DEFINITION OF LIFE INSURANCE

Our second major area of concern is the proposed section 101 guidelines. As one of the major Universal Life writers in the country, we find that the proposal would have a negative impact on this segment of our business and that it would have an adverse effect on our policyholders.

The TEFRA amendments to section 101 provided adequate guidelines for the qualification of Universal Life as life insurance. Universal Life Writers went to great expense modifying their policies and computer systems to assure continued section 101 qualification of their costumers' policies. We are not aware of any reported abuses under these rules.

While we support the concept of a definition of life insurance similar to that of section 101(f) of TEFRA, we would not agree that the test in the Stark-Moore proposal is the correct one. These proposed guidelines would greatly restrict the use of Universal Life and other flexible premium products for normal insurance purposes by possibly requiring policyholders to stop premium payments at some future time, to withdraw part of their cash values, or to increase policy face amounts in an effort to stay in compliance.

Section 101 amendments should be designed to prevent only those abuses which have been clearly identified and not unduly restrict the sale of legitimate flexible premium and traditional life insurance products. We believe that this can be accomplished by the extension of the TEFRA section 101 guidelines to cover all life insurance policies.

One particular troublesome aspect of the proposal is the lack of a guideline single premium limitation. Existing policyholders would be penalized by limiting their flexibility and alternatives. For instance, policyholders could no longer move their insurance coverage and cash values to more flexible consumer oriented products. The guidelines must, therefore, be revised to include a single premium limitation to accommodate such policyholder initiated rollovers.

The guidelines would also have a significant impact on our traditional life insurance products. For instance, endowment at 65, 20-year endowment, 20-pay endowment at 65, and college education endowment policies would not meet the proposed section 101 tests for some or all issue ages. We have marketed most of these traditional products for fifty years or more and they have been recognized even longer as basic products to meet specific legitimate insurance needs.

Furthermore, we would object to the proposed current taxation of earnings on the reserve of a policy failing the section 101 test, and would advocate that the timing of the taxability follow the exisitng annuity rules.

CONCLUSION

In conclusion, we would agree that the Stark-Moore proposal provides a useful framework around which to develop a permanent solution to the taxation of life insurance companies. The changes that we have proposed are absolutely essential to the continued financial and competitive viability of Liberty Life and other companies our size. Again, we appreciate this opportunity to appear before you today, and welcome a chance to work with you in finalizing a permanent tax package.

Mr. Jenkins. Mr. Flippo?

Mr. Flippo. I have no questions.

Mr. Jenkins. Mr. Moore.

Mr. Moore. Mr. Chairman, I want to thank all the witnesses. I think they pointed out to us the problems that the definitions cause to universal life. That is something, I think, we will take a good hard look at. I am not sure we intended that result.

Second, the traditional rule has come up before and we know it is a problem. We thank you for bringing it to our attention and we will be looking at it.

Mr. Jenkins. Mrs. Kennelly.

Mrs. Kennelly. I would like to thank the panel also.

I have just one quick question on page 8 of the written testimony. I see under your estimates the 1959 act would produce about $3.3 billion in taxes

We have been hearing up until now that that figure would be $4.7 million. I wonder how you get a different sum than we have heard from Treasury this morning and than we have in our own papers.

It is on the top of page 8. Current estimates are that the 1959 act would produce about $3.3 billion in taxes.

Mr. Overberg. Yes. Well, we believe that the more accurate figures are less than what the original calculations were and that is where the industry's current best estimates are less than the 4.5 that had been originally estimated.

Mrs. Kennelly. So this is your own computation?

Mr. Overberg. Yes, in connection with the industry. Some other industry people on revenue estimated.

Mrs. Kennelly. That is a difference of $1.4 billion, which is certainly different than what we have been thinking and talking about.

Mr. Overberg. Yes, that is why we have about $1 billion more than the other cost.

Mrs. Kennelly. Thank you very much.

Mr. Jenkins. I want to thank the panel for your testimony and I want to assure each of you that your entire testimony will be considered by this subcommittee.

Thank you very much.

Our next panel is Jim Martin of Massachusetts Mutual; Mr. Douglas Bell, who has with him, I believe, Mr. John Kelly; Mr. John Creedon of Metropolitan Life; and Mr. Harry Garber of Equitable Life Insurance.

Would that panel please come forward and have a seat?

I want to welcome the panel to the committee. Your entire written statements will be made a part of the record, so we would hope that you could summarize and keep as closely to the 5-minute time limit as possible. If you need additional time on some particular point, I am sure we will be very liberal in the transitional rules on that particular point but we would like to move along.

Mr. Martin, we will commence with your testimony and we are delighted to have you before the committee.

STATEMENT OF JAMES R. MARTIN, CHAIRMAN OF THE BOARD, MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

Mr. **Martin**. Thank you, sir.

Mr. Chairman and members of the subcommittee, I am Jim Martin, chairman of the board of Massachusetts Mutual Life Insurance Co.

We applaud the process which has been used by the subcommittee and staff to develop a life industry tax bill. In fact, I believe the process you are following may become a model for the development of future tax legislation for others.

I appreciate the opportunity to contribute to the development of the industry tax proposal. In this regard, I also appreciate your assurance that there will be continuing discussions on this subject.

Out of this dialog, based on the structure which you have proposed, a bill can be developed which we and other mutual companies can accept.

Today I want to cover primarily the impact of the committee proposal on Massachusetts Mutual. Specifically, I want to demonstrate its impact on our company Federal tax liability and on the pricing of our products—and to comment briefly regarding the deduction of policy loan interest. I will also touch on the definition of life insurance.

First, a short explanation about the nature of my company and its operations will help make my remarks meaningful. Massachusetts Mutual is a traditional mutual life insurance company. We sell our products through 116 general agencies located throughout the United States. We sell all lines of life insurance products including individual life and annuities and disability coverage, universal life, and group life, health and pensions.

For us the most essential point in the development of a new tax law is that it result in competitive equity between products sold by all companies—both stock and mutual. Lack of tax equity would, of course, have a substantial adverse effect.

As an illustration, we were literally driven out of the market for individual annuities in the seventies because the tax law then favored stock companies on annuity products.

Our general view is that the structure of the tax proposal which you have developed is a foundation upon which a sound tax law for all the life insurance industry can be built.

My chief concern is with respect to the rates and definitions which have been used in applying the structure to the mutual segment of the business. From this point forward, my comments on ownership differential will address only the rates and definitions applied. Please note that my comments address only the rates and definitions and should not be considered a criticism of the structure which has been developed.

My understanding is that you intended this differential to be a minimum tax which would prevent mutual companies from "dividending out" of their tax liability. Unfortunately, the present rates and definitions will not work this way.

Our general concern with the ownership differential as proposed is that it is so large that it would, in fact, become the tax base for almost all mutual companies. As a result, mutual companies would not be taxed on their economic income.

We also believe that any minimum tax should be applied to all companies—both stock and mutual. Stock companies are moving pellmell toward marketing products with flexible pricing features. If policyholder dividends and similar distributions are cause for minimum tax on a mutual company, they are cause for minimum tax on a stock company as well.

The impact of the ownership differential on the tax liability of the Massachusetts Mutual is dramatic. Under it, in 1984 Massachusetts Mutual would pay Federal income tax of $143 million. However, if we were taxed as a stock company, our tax liability would be only $49 million.

This difference is in fact even greater because approximately $21 million of the stock company tax results from the runoff over 10 years of reserves which would no longer be allowed. Thus, the long-term impact would be a tax of about $28 million if we were a stock company compared to a tax of about $143 million if we were taxed as a mutual company—a tax five times as great for mutual as for an identical stock.

I am confident that such a differential in tax liability simply because of our form of organization was not intended. As you can see with such a lopsided tax burden, we clearly could not continue in business in competition with stock companies.

The impact of the proposal on the level of dividend deductibility would also make it impossible for us to compete for new business. The result would be a higher cost product for our new policyholders.

Let's first take a look at universal life. If we were taxed as a stock company, we would be able to credit 10½-percent interest on universal life policy. However, assuming the same profit criteria, if we were taxed as a mutual company, we would be able to credit only 9 percent.

The cumulative effect of this 1½-percent differential is dramatic. An illustration prepared for age 40 would normally show values at retirement, age 65. Thus, an investment of $10,000 would accumulate to $121,000 at 10½ percent. But at 9 percent, it would accumulate to only $86,000. The higher interest rate paid by a stock company would result in accumulation of an extra $35,000 or 40.7 percent more.

The impact on our individual whole life product is equally dramatic. Individual life policies are normally compared by use of the 20-year, interest-adjusted net cost. It is not necessary to go into detail here as to how this index is derived.

And, please, just accept, in the interest of time, my statement that a difference of 25 cents in interest-adjusted cost is significant and a dollar is overwhelming.

Under the proposal, the interest-adjusted cost of our individual whole life product would be $2.30 higher solely because we are taxed as a mutual company rather than as a stock. This $2.30 difference in net cost clearly leaves a wide margin for stock company profit in addition to a price differential which would drive us out of the market.

The ownership differential with its original definitions and rates would also seriously disadvantage Massachusetts Mutual's ability to invest in the particular types of investments that are necessary to support certain products.

The fact that we and most other mutuals would always be on the minimum tax base means that we could receive no benefit from investment in tax exempts, receipt of intercorporate dividends, or realization of market discount and capital gains.

However, our stock competitors would continue to receive these tax benefits. This would surely drive us out of certain sales and investment markets.

I applaud the subcommittee for proposing a strict definition of life insurance. Such a definition is necessary to prevent investment contracts disguised under a thin veneer of insurance risk from receiving the tax benefits traditionally accorded life insurance. Our concern is the long-term protection of those benefits.

Policy loan interest: The denial of a deduction for interest on policy loans would do significant harm to our policyholders and agents.

If curtailments must be made in this area, we urge that the grandfather provision apply to all existing policies and not just to existing loans. This is appropriate because existing policyholders bought their contracts with the understanding that interest on policy loans could be deducted.

It is also appropriate to limit any curtailment to future policies because agent compensation is based to a large extent on whether policies they have sold continue in force. Without an adequate grandfather provision, substantial blocks of existing business will lapse with a consequent large reduction in agent compensation. You may hear from agents with respect to this.

Finally, the allowance of a deduction for interest on only $50,000 of loans would be far too restrictive. Today this amount would cover only one college education and one very used car.

Mr. Chairman and committee members, let me express once more our admiration and appreciation for the massive amount of time and effort you and your staff are devoting to our problems, for the fair and innovative process you are using to develop a permanent tax bill, and for the sound and equitable structure on which this proposal is based.

I am confident that by properly adjusting along the lines suggested, you will create an equitable life insurance tax bill of which you can be proud and under which all companies can thrive.

Thank you very much.

Chairman **Stark** [presiding]. Thank you very much, Jim.

[The prepared statement follows:]

STATEMENT OF JAMES R. MARTIN, CHAIRMAN, MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

Mr. Chairman and members of the subcommittee, I am Jim Martin, Chairman of the Board of Massachusetts Mutual Life Insurance Company.

We applaud the process which has been used by the subcommittee and staff to develop a life industry tax bill. In fact, I believe the process you are following may become a model for the development of future tax legislation for others. I appreciate the opportunity to contribute to the development of the industry tax proposal. In this regard, I also appreciate your assurance that there will be continuing discussions on this subject. Out of this dialogue, based on the structure which you have proposed, a bill can be developed which we and other mutual companies can accept.

Today, I want to cover primarily the impact of the committee proposal on Massachusetts Mutual. Specifically, I want to demonstrate its impact on our company federal tax liability and on the pricing of our products—and to comment briefly regarding the deduction of policy loan interest. I will also touch on the definition of life insurance.

First a short explanation about the nature of my company and its operations will help make my remarks meaningful. Massachusetts Mutual is a traditional mutual life insurance company. We sell our products through 116 general agencies located throughout the United States. We sell all lines of life insurance products including individual life and annuities and disability coverage, universal life, and group life, health and pensions.

OVERVIEW OF THE PROPOSAL

For us the most essential point in the development of a new tax law is that it result in competitive equity between products sold by all companies—both stock and mutual. Lack of tax equity would, of course, have a substantial adverse influence on our ability to compete. As an illustration, we were literally driven out of the market for individual annuities in the 70's because the tax law then favored stock companies on annuity products.

Our general view is that the structure of the tax proposal which you have developed is a foundation upon which a sound tax law for all the life insurance industry can be built. It reflects the application of sound tax principles to our industry.

My chief concern is with respect to the rates and definitions which have been used in applying the structure to the mutual segment of the business. From this point forward, my comments on ownership differential will address the rates and definitions to be applied. Please note that my comments address only the rates and definitions and should not be considered a criticism of the structure which has been developed.

OWNERSHIP DIFFERENTIAL

My understanding is that you intended this differential to be a minimum tax which would prevent mutual companies from "dividending out" of their tax liability. Unfortunately, the present rates and definitions will not work this way. Our general concern with the ownership differential as proposed is that it is so large that it would in fact become the tax base for almost all mutual companies. As a result, mutual companies would not be taxed on their economic income which is the goal they have long sought and a goal which we believe that you share.

We also believe that any minimum tax should be applied to all companies—both stock and mutual. Stock companies are moving generally toward marketing products with flexible pricing features. If dividends and similar distributions are cause for a minimum tax on a mutual company, they are cause for a minimum tax on a mutual company as well. Similar products should cause similar tax consequences for all companies.

Before discussing the impact of the ownership differential on Mass. Mutual please note that the figures I will present are based on our best interpretation of the proposal. We have been forced to make our own judgment regarding the meaning of many points which may be of significance to the result. You and the staff should be aware of this.

The impact of the ownership differential on the tax liability of the Massachusetts Mutual is dramatic. Under it, in 1984 Massachusetts Mutual would pay federal income tax of $143 million. However, if we were taxed as a stock company our tax liability would be only $49 million. This difference is in fact even greater because approximately $21 million of the stock company tax results from the run-off over ten years of reserves which would no longer be allowed. Thus, the long-term impact of the proposal would be a tax of about $28 million if we were a stock company compared to a tax of about $143 million if we were taxed as a mutual company. This means a tax five times as great for a mutual as for an identical stock.

I am confident that such a differential in tax liability simply because of our form of organization was not intended. As you can see with such a lopsided tax burden, we clearly could not continue in business in competition with stock companies.

The disproportionate tax burden on mutuals would have an unwarranted adverse impact on our present policyholders. One way to demonstrate this is to express the result in terms of the deductability of dividends. If our current dividend scale is maintained, we estimate that under the proposal "as is" in 1984 we could deduct only 23 percent of our dividends. We would then be forced to reduce our dividends by substantially over 20 percent just to pay our taxes. Such a reduction in dividends would increase the cost to policyholders of their insurance coverage. It would be an indirect tax increase for our 1.4 million policyholders.

The impact of the proposal on the level of dividend deductibility would also make it impossible for us to compete for new business. The result would be a higher cost product for our new policyholders. Let's first take a look at universal life. If we were taxed as a stock company, we would be able to credit 10½ percent interest on universal life policy. However, assuming the same profit criteria, if we were taxed as a mutual company, we would be able to credit only 9 percent. The cumulative effect of this 1½ percent rate differential is dramatic. An illustration prepared for age 40 would normally show values at retirement, age 65. Thus, an investment of $10,000 would accumulate to $121,000 at 10½ percent. But, at 9 percent, it would accumulate to only $86,000. The higher interest rate paid by a stock company would result in accumulation of an extra $35,000 or 40.7 percent more. That is a competitive burden which a company like Massachusetts Mutual could not endure.

The impact on our individual whole life product is equally dramatic. Individual life policies are normally compared by use of the 20-year interest-adjusted net cost. It is not necessary to go into detail here as to how this index is derived. It is sufficient if you accept my assurance that a difference in this index of 25 cents is considered competitively significant and a difference of $1.00 is competitively overwhelming. Under the proposal, the interest-adjusted cost of our individual whole life product would be $2.30 higher solely because we are taxed as a mutual company rather than as a stock. This $2.30 difference in net cost clearly leaves a wide margin for stock company profit in addition to a price differential which would drive us out of the market.

The ownership differential with its original definitions and rates would also seriously disadvantage Mass. Mutual's ability to invest in the particular types of investments that are necessary to support certain products. The fact that we and most other mutuals would always be on the minimum tax base means that we could receive no benefit from investment in tax exempts, receipt of intercorporate dividends, or realization of market discount and capital gains. However, our stock competitors would continue to receive these tax benefits. This would surely drive us out of certain sales and investment markets.

I have tried to explain the impact of the ownership differential proposal on the Massachusetts Mutual and its products. As noted before though, the structure can be made to work. Let me suggest how.

First, the equity base should not include the policyholder dividends reserve.

Second, investment assets not admitted because they are in default should be excluded.

Finally, and most important, the rate to be applied to the equity base should be tied to the operational results of each individual company. It should not be an artificially derived rate applied generally to all mutuals. Operational results can best be measured by the rate of return actually earned by the company on its investment portfolio. It may be necessary to adjust this rate to eliminate the depressive effect of policy loans. This then would give a realistic earnings rate.

One final point with respect to ownership differential. We and other mutal companies went to work with the Subcommittee and staff in developing a sound permanent tax law which will achieve objectives that we share. To this end we want to develop an ownership differential which will prevent abuse. In the normal case where there is no such abuse, our tax should be based on economic income. The ownership differential will not work if it creates an alternate mutual company tax base that comes into play except in abnormal circumstances.

SUBSIDIARIES

We also could be hurt by the proposal to tax stock subsidiaries of mutuals as mutual companies and not as stocks. I should note though that if mutual companies are taxed properly, with an appropriate amount of ownership differential, there will be little, if any, reason to care whether subsidiaries of mutual companies are taxed as stocks or as mutuals.

GROUP INSURANCE

The group life and health division of Massachusetts Mutual has been concerned for years about its inability to compete in a group insurance market where stock companies have a special tax advantage. We note your proposal would eliminate this special tax differential for group products and urge you to adhere to this position in the bill reported out by the Subcommittee.

DEFINITION OF LIFE INSURANCE

I applaud the Subcommittee for proposing a strict definition of life insurance. Such a definition is necessary to prevent investment contracts disguised under a thin veneer of insurance risk from receiving the tax benefits traditionally accorded life insurance. Our concern is the long term protection of those benefits.

POLICY LOAN INTEREST

The denial of a deduction for interest on policy loans would do significant harm to our policyholders and agents.

If curtailments must be made in this area, we urge that the grandfather provision apply to all existing policies and not just to existing loans. This is appropriate because existing policyholders bought their contracts with the understanding that interest on policy loans could be deducted. It is also appropriate to limit any curtailment to future policies because agent compensation is based to a large extent on whether policies they have sold continue in force. Without an adequate grandfather provision, substantial blocks of existing business will lapse with a consequent large reduction in agent compensation. You may hear from agents with respect to this.

Finally, the allowance of a deduction for interest on only $50,000 of loans would be far too restrictive. Today, this amount would cover only one college education and one very used car.

Mr. Chairman and Committee members, let me express once more our admiration and appreciation for the massive amount of time and effort you and your staff are devoting to our problems, for the fair and innovative process you are using to develop a permanent tax bill, and for the sound and equitable structure on which this proposal is based. I am confident that by properly adjusting along the lines suggested, you will create an equitable life insurance tax bill of which you can be proud and under which all companies can thrive. Thank you.

APPENDIX.—MASSACHUSETTS MUTUAL TAX BEFORE CREDITS

[In million of dollars]

	1983	1984
1959 act	99.4	116.3
TEFRA basis	38.9	42.5
Proposal—mutual rules	126.3	142.8
Proposal—stock rules	45.8	49.0

Chairman **Stark**. The next witness is Mr. Bell of the State Mutual Life Assurance Co. of America.

STATEMENT OF W. DOUGLAS BELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, STATE MUTUAL LIFE ASSURANCE CO. OF AMERICA

Mr. **Bell**. Thank you, Mr. Chairman.

My name is Douglas Bell. I am the chairman of State Mutual Life Assurance Co. of America, which is headquartered in Worcester, Mass.

Let me briefly try to identify my company. We are the fifth oldest life insurance company in America, founded in 1844. We are known as a medium-size mutual, although I must say that companies like Prudential and Connecticut General, which have already testified, are anywhere from 5 to 20 times our size.

Obviously we would like to grow. We believe very strongly that the economies of scale are increasingly important to our survival.

Mr. Chairman, we have submitted testimony covering those specific matters on which you asked us to comment. This afternoon I am going to try to summarize that written testimony.

I will limit my comments primarily to the specific impacts on my own company and I will certainly try to be brief as you have requested.

As to our tax position, we estimate that State Mutual's actual tax before credits in 1984 under your proposal would be $32.3 million as compared to $8.5 million under stopgap and $15.2 million under the 1959 act. Not only would our tax increase four times under your proposal as compared with present law, but further, because of the minimum tax feature, we would not be able to deduct any or only a very small percentage of the dividends we pay to our policyholders each year.

Now, notwithstanding these rather startling figures, at least from our point of view, Mr. Chairman, we do feel the subcommittee approach is generally conceptually sound. As with others, we have some serious problems with several of its provisions.

First, and again as others have testified, we are seriously concerned with both the level and the method of computing the so-called ownership differential. The subcommittee's proposal coupled with the proposed 23 percent rate would, in our case, mean that we would never be taxed on our actual economic income but we would always be taxed on a higher minimum return on equity basis.

As with other witnesses, and I am not going to expand on this, let me just say that we believe the policyholders' equity is overstated as proposed because, among other things, it does not recognize the unrealized loss in our bond and mortgage portfolio.

We also believe the proposed 23 percent rate is too high and that it would be more appropriate to utilize a tax basis rate of return currently earned by stock life companies.

We also have to recognize, Mr. Chairman, that the proposal as it stands would create some very severe competitive disadvantages for us, vis-a-vis stock companies and other financial institutions, in at least two areas: first, our ability to grow; and second, our ability to use tax favored investments.

As Mr. Alan Richards has just testified a few minutes ago, insurance sales produce a current loss because of high first-year acquisition expenses. We believe that a rapidly growing stock company should quite properly be able to use those new business losses to shelter its earnings on shareholder equity. These deductions would not be available to us, however, since we would be required to pay a tax based on the minimum return on policyholders' equity.

If the method you have proposed is to be followed, we would certainly suggest a reduction in the minimum return on equity for any acquisition expenses in excess of first-year premiums. I would like to just interject a brief example here.

In our case, the interest credited to the policyholder on a new universal life product would have to be reduced from 10 percent to a less competitive 9¼ percent if we were on a minimum return on equity basis and acquisition cost losses could not be used.

Another area where we see a severe competitive problem is with respect to our use of tax-favored investments. Others have commented on this. We feel an identical stock company or bank would have a substantial pricing advantage through the use of discount bonds or other tax-favored items which would enable them to obtain a superior after-tax rate of return.

Chairman **Stark**. Mr. Bell, if I could interrupt, when you say you would have to drop the return from 10 to 9¼ percent, that is a function of the amount of tax that you pay. If I calculate the same exact tax another way, you would still have to reduce that, wouldn't you?

Mr. **Bell**. What I was attempting to illustrate, Mr. Chairman, is that there would be a 75 basis point differential merely by our inability to deduct our acquisition expenses; whereas——

Chairman **Stark**. I am not sure that is true unless under some other plan the tax you paid was the same. If the tax was different, your illustration wouldn't hold. You can use that in a marginal tax computation, if you assume that your marginal tax rate is going to be different; but if you assume the same aggregate tax dollars, I am not sure your illustration flies.

Mr. **Bell**. We would always be on the minimum return on equity.

Chairman **Stark**. You used an illustration that said in a competitive sense in a universal life product, you would have to reduce the return from 10 to 9¼ percent because of a particular way you will calculate your tax. I am suggesting if we calculate the exact dollars in taxes the same way, to get to the same total dollar tax, are you still going to have to reduce?

Mr. **Bell**. If we got to the same dollar of tax, yes.

Chairman **Stark**. I suspect you are applying a marginal rate computation to a product without looking at the aggregate taxes your company pays.

Mr. **Bell**. I am applying this specifically to the product.

Chairman **Stark**. I am afraid you are trying to sneak one by me. I may look asleep, but I just don't think that that is—on a basis if you assume your marginal rate differs—but I am not sure that you are talking about aggregate tax. If you are going to pay $1 million in taxes, it makes no difference to you whether I calculate it with a pocket calculator or what kind of formula I use—it is the million dollars in taxes. And, therefore, any way we calculate your tax would have the same effect on your product.

If you want to apply a marginal tax——

Mr. **Bell**. Certainly, Mr. Chairman, I would accept that. And the sole point I was trying to illustrate was that I would like to be able to have a deduction for acquisition expenses comparable to that of a stock company.

Chairman **Stark**. Even if you had a higher tax?

Mr. **Bell**. Oh, no, sir.

Should I proceed, sir?

Chairman **Stark**. Yes.

Mr. **Bell**. We think we would also be very much affected by our inability to use tax-favored items to obtain a superior after-tax rate of return. Others have commented on that. I would like to only make one point on that.

We would have a difficult situation, because my company has a substantial investment in the stock of a property and casualty company. We happen to own 51 percent of this company that, incidentally, in terms of revenue, is approximately the same size as State Mutual.

Last year our carrying value for the subsidiary increased by approximately 45 percent, largely due to improvement in the value of—the Hanover Insurance Co. happens to be the name of the company—to improvement in the value of its common stock portfolio.

Now, if we were in a position where we are taxed on the minimum return on equity base, this increase in the carrying value of our subsidiary would produce in our case an annual additional tax of $3.2 million because of this completely unrealized fluctuation in market value. Thus, it would become almost prohibitive for us to hold this and other stock investments, since the tax-favored attributes of stock would be lost; and, in fact, in our case a tax penalty would be paid.

Chairman **Stark**. Mr. Bell, run that by me again. Are you suggesting that in the calculation of your surplus or the imputed equity, because of it—because of your ownership in a casualty company, your equity base would be increased?

Mr. **Bell**. Yes, sir.

Chairman **Stark**. Well, I am not sure that unless—are you carrying that merely as an investment and not consolidating?

Mr. **Bell**. We carry it purely as an investment. We have a 51-percent position in that company.

Chairman **Stark**. 51 percent of General Motors or Chrysler, you would be in the same position, wouldn't you?

Mr. **Bell**. I would be carrying that stock, Mr. Chairman, at market. And under statutory accounting, because we do have a control position, we are required to carry it on a cost adjusted basis.

Chairman **Stark**. Couldn't you carry it just as an investment?

Mr. **Bell**. We do carry it just as an investment, but on a cost adjusted basis.

Chairman **Stark**. Is that lower than market?

Mr. **Bell**. Currently, it is slightly lower than market, yes, sir.

Chairman **Stark**. As I say, I am not sure that that again is—well, if you own half of General Motors, you would have a control position and you would be very lucky. But I congratulate you on your—I wish my investments turned out that well, but they didn't.

Mr. **Bell**. We are very happy with our position with this particular company and this increase in its carrying value. However, this is not—or this is nothing we have realized. The only way we could realize that gain would be if we chose to sell that company, which we do not wish to do.

Chairman STARK. Are you continuing market to market; you mark that investment to market?

Mr. BELL. No. If we were to sell it—and I am not sure what we could sell it for—we would then realize whatever the value of that company was. But what has happened to us currently is that under this proposal, because there is this unrealized gain in the common stock investments of the subsidiary, we end up with an additional $3.2 million of tax because of its impact on our equity.

Next year, that may be down. I don't know what the market will do.

Chairman STARK. I don't know. I mean, you say you are treating that as a portfolio investment, and you revaluate it each year for whatever purpose in your balance sheet; that would be correct. But if you are carrying it at cost, as I am sure you do your bonds, why would it change your equity calculation?

Mr. BELL. Because we have this appreciation in the common stock portfolio of the company which is reflected in our cost adjusted basis for carrying the stock.

Perhaps I am not grasping your question.

Chairman STARK. There seems to be some reason that this casualty company is different from the stock you may own in any other part of your investment portfolio.

Mr. BELL. The point is that we are carrying it at book value. Perhaps I am not grasping your point.

Chairman STARK. I don't see this.

Mr. BELL. I think, Mr. Chairman, it is a quirk in the proposal which I am quite sure was not anticipated.

Mr. Groom helpfully reminds me that this gets included in our mandatory security valuation reserve which is included in the base as proposed, and therefore that increases our base accordingly.

Chairman STARK. It seems to me, however, that that is a controllable item and is really basically—well, it is a voluntary decision on your part to carry the investment, and I suppose it is one of those unique problems that might have to be worked out.

In determining, it seems to me that if this were held in any other situation as an asset and then consolidated after the net income of your life insurance business, that you wouldn't have this problem. And I fail to understand why this has to affect your equity calculation any more than any other stock that you would own.

Mr. BELL. Perhaps this is where I have been confusing in my testimony. This result would be the same for any common stock held by a mutual company which is taxed on the minimum tax on equity basis, because the unrealized appreciation raises the ultimate tax to us, because it increases that equity, even though we have not realized on that, on the capital gains.

Chairman STARK. You raise the value of this stock in your statement each year?

Mr. BELL. Yes. If it goes up, yes.

Chairman STARK. Do you do that with all the stock you hold in your investment portfolio, even though you don't sell it?

Mr. BELL. Yes, sir; unrealized gains on stock would increase the equity base.

Chairman **Stark**. What do you do with unrealized loss in bonds and mortgages?

Mr. **Bell**. We carry bonds and mortgages as required by statutory law at cost, not at market. Currently, we have a large unrealized loss.

Chairman **Stark**. We would solve your problem if we just made the decision to take care of everything at book or mark everything to market. In your case, you reduce it by the market value of your bond portfolio, which I am sure manages to go down as much as the stock.

I have a hunch I see what you are saying. I don't know as that really gets to the basic structure of computing an equity base and putting an imputed earning on it.

Proceed.

Mr. **Bell**. I would suggest, Mr. Chairman, one way that that problem could be solved would be to eliminate the mandatory security valuation reserve from the base, but I know you don't want to.

Chairman **Stark**. I am prepared to offer 50-percent maximum deductibility of dividends as an alternative.

From there, we will find it a lot more interesting to compute the equity and some function that will get us to somewhat higher than a 50-percent deductibility of dividends.

Mr. **Bell**. I am in no position to accept your offer, and I am certainly not being facetious. I would welcome the opportunity for some of my people to try and make this point more clearly than I obviously have made it with you and with your staff, and we would be happy to try and do this a little better.

Should I continue, sir?

Chairman **Stark**. Please do.

Mr. **Bell**. I want to make another point here without belaboring this question of whether we are under this proposal basing a minimum tax on surplus. I think we all would agree that the surplus becomes a part of that computation, and I simply want to make the point that smaller companies, such as State Mutual, do tend to have, and in my personal opinion require, higher surpluses than do the larger companies.

My own company's ratio of statutory surplus and investment reserves to assets exceeds the average ratio of the five largest mutuals by almost 2 percentage points. That is about a 40-percent differential. And we consider that our level of contingency reserves is both necessary and proper for us, and I would urge consideration of my belief that the smaller company needs more surplus, both to compensate for the great volatility of its investment and operational results, as well as to finance its future growth.

Chairman **Stark**. Are you under $500 million in assets? Less than?

Mr. **Bell**. No, sir. We are approximately $3 billion in assets.

Chairman **Stark**. That is small?

Mr. **Bell**. Relative to Prudential and Connecticut General.

In my opening comment, Mr. Chairman, I tried to indicate that we are considered a medium-sized mutual. We are in the top 40 stock and mutual companies, within the top 20 mutual companies. So I still make the point that it is our belief that a company of our size requires a larger surplus to finance future growth to protect itself on volatility than do the giants, if I may use that term.

We would urge that any minimum return on equity base be graded to reflect the size of the company or that somehow a cap or a limit on the size of the minimum equity base might be permitted to help smaller companies relatively, and I am not commenting on the so-called small company panel that previously testified.

Let me comment, Mr. Chairman—and I will indeed try to be very brief on this one—on the subcommittee's proposal on reserves. We are concerned with the proposed transitional rule which requires the difference in old basis and new tax basis reserves to be included in income over 10 years. It seems to us, Mr. Chairman, that if the subcommittee proposal as ultimately modified properly measures our taxable income for 1984, then it somehow seems improper to be further taxed on the release of previously held reserves for which we received little or no tax benefit when those reserves were established.

Accordingly, we would urge consideration of a tax benefit rule whereby only the actual tax benefit received be returned to income in post-1983 years.

Finally, Mr. Chairman, our written submission includes specific proposals for achieving what we would consider to be an appropriate ownership differential. I want to say that if adjustments of the nature we have indicated could be considered, and hopefully included, I believe personally that the subcommittee's proposal could provide a workable basis to tax my own company.

I do appreciate this opportunity, and I would be happy to try to respond to any further questions.

[The prepared statement follows:]

STATEMENT OF W. DOUGLAS BELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, STATE MUTUAL LIFE ASSURANCE COMPANY OF AMERICA

My name is W. Douglas Bell. I am Chairman of the Board and Chief Executive Officer of State Mutual Life Assurance Company of America. State Mutual, the fifth oldest life insurance company in America, is headquartered in Worcester, Massachusetts, and has been in the life insurance business since 1844. We're a medium sized mutual, in the top forty stock and mutual companies by most measures, although companies like Aetna and Prudential are ten and twenty times our size. We'd like to grow—the economies of scale are increasingly important to our survival.

The attached Exhibit 1 shows the taxable income our operations would produce in 1984, and also for 1982 and 1983, computed on the basis of the 1959 Act, Stopgap and the Subcommittee proposal.

While we feel that the Subcommittee approach is in general conceptually sound, we have some serious problems with several of its provisions and I would like to comment on three of those:

1. The level of the ownership differential between stocks and mutuals and the method of computing it;
2. The treatment of stock life insurance subsidiaries of mutual life companies as mutuals; and
3. The full inclusion in gain from operations of the difference between old basis tax reserves and new basis tax reserves even though much of this reserve difference never resulted in a full tax benefit.

1. Ownership differential.—It can be seen from the attached Exhibit 1 that our policyholders' equity as defined by the Subcommittee proposal was approximately $365 million at year end 1982, which at the proposed 23 percent rate produced a minimum return on equity of about $84 million. Since our operations produced a tax basis gain before policyholder dividends of approximately $75 million, we would not have been able to deduct any policyholder dividends at all under the proposal had it been in effect in 1982.

Furthermore, we believe that policyholders' equity is overstated as proposed largely because it does not recognize the substantial overvaluation of bonds and mortgages in our portfolio that results from statutory valuation requirements that we carry these investments at book value, rather than at market. At year-end 1982, we had a $1.8 billion bond and mortgage portfolio yielding approximately 9.5 percent and with an average maturity of about ten years. We estimate that market value was about $270 million lower than our carrying value. This adjustment would reduce our policyholder equity to approximately $95 million, or one-quarter that of the Subcommittee proposal. Also, the 23 percent rate is, I believe, a financial statement rate of return, while a tax basis rate of return currently earned by stock life companies would be more appropriate to apply to equity to achieve tax comparability between mutuals and stocks. We suggest that if the Subcommittee's method is to be followed, policyholder's equity should clearly be reduced by the unrealized loss on bonds and mortgages and that a stock life tax basis rate of return should be used.

We have some other practical problems with the way the policyholder dividend disallowance is developed through the return on equity base.

The Subcommittee proposal would tax us and most other mutuals on a minimum return on equity base and not on our economic income. While the minimum return on equity approach may be theoretically sound, even a lower and appropriately sized minimum return on equity creates competitive disadvantages for us vis a vis stocks in at least two areas: (1) our ability to grow and (2) our ability to use tax favored investments.

GROWTH

New insurance sales produce a current loss because of high first year acquisition expenses. A rapidly growing stock company will quite properly be able to deduct and use such "new business" losses to shelter its earnings on shareholder equity or to shelter the income of affiliates through consolidation. An identical growing mutual would be unable to deduct new business expenses and would be required to pay a tax based on the minimum return on policyholders' equity. A growing stock company would enjoy a pricing advantage because of its ability to make current use of its tax loss while our new business loss would disappear without benefit. If this method is to be followed, we suggest a reduction in the minimum return on equity to reflect these new business losses. For example, our new universal life product would have to be credited at a rate of 9.25 percent if we were on the minimum return on equity base versus 10 percent if acquisition cost losses could be used.

TAX FAVORED INVESTMENTS

Another area where we see a severe competitive problem is with respect to our use of tax favored investments such as stocks, real estate, discount bonds, etc. If we were limited by a minimum return on equity, an identical stock company or bank would have a substantial pricing advantage through the use of discount bonds or other tax favored items to obtain superior after-tax rates of return. If we were in fact on the minimum return on equity base, we would necessarily have to invest in fully taxable items, such as current coupon bonds and mortgages. We could not take advantage of the tax benefits and after-tax rates of return offered by discount bonds, real estate, equipment leases or stocks since the pricing of those investments is not attractive if we cannot make use of their favorable tax attributes.

For example, we would be severely affected in this regard with respect to our offering of individual annuities for IRAs or other qualified plans. We are currently offering an 11 percent IRA rate by investing in discount bonds. We are currently competitive, although a number of insurers offer higher rates and banks have comparable government insured rates. Were we to be taxed on the basis of minimum return on equity, we would not be able to obtain a competitive after-tax rate of return through the use of discount bonds. Our best investment would be a fully taxable current coupon bond which will support a rate of only 9 percent. (See the attached illustrations shown in Exhibit 2.)

Since rates for IRAs offered by banks and stock companies are generally over 10 percent in the current market, we would expect to be noncompetitive on this product solely because both banks and stock companies are free to obtain the favorable after-tax advantages of investments such as discount bonds. This would similarly affect our ability to compete in the new universal life market.

The competitive disadvantage we would suffer from stock life insurers and other financial intermediaries with respect to tax favored investments would particularly hurt us since we have a substantial investment in the stock of a property and casualty insurance company. We own 51 percent of the stock of this property and casualty company that in terms of revenue is approximately our own size.

Our carrying value for this subsidiary increased from $96 million at last June 30 to $137 million at this June 30, largely the result of stock market improvement. If we were to be taxed on the minimum return on equity base, this increase in the carrying value of our subsidiary, largely attributable to stock market improvement, would produce an annual additional tax of $3.2 million on this unrealized fluctuation in market value.

If we are taxed on the minimum return on equity basis as proposed, it would become prohibitively expensive for us to hold stocks, since their tax favored attributes would be lost and, in fact, a tax penalty would be paid. The proposal imputes a 23 percent taxable return to market value, while the actual market price of stocks is based on their producing taxable income of 1 percent or so, with no tax on unrealized appreciation. Were the Subcommittee proposal to permit use of our own portfolio rate of return on investments rather than a presumed 23 percent rate, this would in part reflect the lower yield of tax favored investments.

We suggest that the minimum return on equity be reduced to reflect tax favored investment items.

THE NEED FOR CERTAINTY

One further practical problem that would arise under the Subcommittee proposal is that we would not be able to calculate, until after the close of the fiscal year in which policyholder dividends were paid, our minimum return on equity and, hence, the amount of dividends deductible. This would seriously impair our ability to determine appropriate dividend levels, information that must be available several months in advance of the year in which dividends are paid.

THE SMALLER MUTUAL AND LESS THAN AVERAGE RETURN ON EQUITY

A return on equity derived from comparable taxable income of all stock life companies should produce a theoretically appropriate average return for all mutuals. However, any average necessarily penalizes that half of companies which is less efficient or less profitable than the average. These companies will be presumed by the Subcommittee proposal to be of average profitability and asked to pay tax on an amount that they are not in fact earning—a tax that does not reflect their economic reality. The smaller and less profitable mutual companies would be penalized. The largest companies presumably have economies of scale (lower unit costs) and should theoretically be able to achieve higher return on equity than smaller companies.

We are also deeply concerned with the effect of basing a minimum tax on surplus. Smaller companies, such as State Mutual, tend to a have higher surpluses than large companies. At year-end 1982, the five largest mutuals had an average ratio of statutory surplus and investment reserves to assets of 5.45 percent. The next seven largest mutuals had an average ratio of 6.2 percent while the next 12 companies, including ours, had an average ratio of 7.0 percent. We note that a similar pattern exists among stock companies. The smaller company needs more surplus both to compensate for the greater volatility of its investment and operational results, as well as to finance its future growth.

In order for small companies to survive in today's competitive financial environment, growth is essential to lower unit costs. Under statutory life insurance accounting, growth can be financed only at the cost of decreases in surplus. State Mutual has not had substantial growth of its insurance business over the past 10 years. We attribute part of this relatively slow growth to the 1959 Tax Act which, by its structure, forced us to raise our prices by not allowing us a tax benefit for the cost of acquiring new business.

Smaller mutuals like us who are attempting to grow will be much more likely to be affected by the minimum return on equity base than larger companies. The larger companies, as mentioned, require smaller surplus ratios, and experience economies of scale that should permit greater return on equity. We urge that any minimum return on equity base be graded to reflect size of company, or that is cap or limit on the size of the minimum equity base (or on the maximum amount of dividends to be disallowed) be permitted.

In addition, the allowance of carryovers and carrybacks of unused dividends in some fashion is necessary, particularly for smaller companies like us who may be affected by the minimum base by reason of any one's temporary growth or volatility of operating results.

2. Treatment of stock life insurance subsidiaries of mutuals.—SMA Life Assurance Company is a wholly-owned stock life insurance subsidiary of State Mutual. We formed this subsidiary in 1967 because many state laws at that time did not permit mutual companies to write variable annuities, and several still do not permit mutuals to write nonparticipating coverages.

As a marketer of nonparticipating individual life, health, annuity and new universal life insurance products, SMA Life, if taxed on a return on equity base, would be disadvantaged vis a vis independently held stock companies by not being able to make similar tax advantaged investments to support the pricing of these products, and by not obtaining a tax benefit from acquisition expense losses.

One of the arguments advanced be some for the treatment of stock subsidiaries of mutuals as mutuals is that such subsidiaries are operated as mutuals. We believe this thinking is wholly without substance.

As previously mentioned, State Mutual has a 51 percent majority interest in a sizeable property/casualty company; the minority interest is publicly held and actively traded on the Over-the-Counter market.

Fifteen years ago, when we acquired control of this company, it was a mature property and casualty insurer in financial difficulty.

Under mutual company parentage, it has become one of the most efficiently operated and profitable stock property/casualty companies. Its dividends to stockholders have been increased steadily over the past ten years, and its stock has been regularly recommended by independent investment services, yielding profits for those who have followed that advice.

Today, many subsidiaries of mutual companies, including our wholly-owned life subsidiary SMA Life, are startup operations. As new insurance companies, their operations will produce losses because of their rapid growth; independently owned stock companies have similar results.

As the success of our property/casualty subsidiary demonstrates, a mature subsidiary of a mutual will be operated as a stock company, and as a good investment for its stockholders.

We urge the Subcommittee to treat stock life subsidiaries of mutual companies as stocks.

3. Transitional Rule requiring the difference in old basis and new basis tax reserves to be included in income over ten years.—Although this provision is not a key conceptual part of the Subcommittee proposal, we do wish to point out that, as proposed, it would have unfair effects on us and many similar companies. This provision suggests that the difference between present law tax reserves and new law tax reserves computed be included in income over a ten year period. This would seem fair where the life insurer obtained a commensurate tax benefit when this difference in reserves was originally set up. In the case of State Mutual, we estimate the difference in reserves at the beginning of 1984 to be $160 million. Most of this amount was set up during years when we were taxed under the 1959 Act on our taxable investment income. We did not obtain a tax benefit at the corporate rate for the establishment of these reserves.

For our Company, a nonpension life reserve in pre-'stopgap' days provided us with a 1.8 percent annual tax reduction as opposed to a tax reduction equal to the full corporate rate for companies taxed on their operating gains. While reserve additions included during the 'stopgap' years did produce tax benefits at the full corporate rate, we feel that our 1981 reserve balances should not be fully included in income since they did not produce a full tax benefit. If the Subcommittee proposal, as ultimately modified, properly measures our taxable income for 1984, then the release to income of previously held reserves for which we received no benefit, or a minor tax benefit, seems to us unfair. Although a "tax benefit rule" might involve some major computational work for us, the dollars are of a magnitude so important to us that we would willingly assume the burden of demonstrating the magnitude of our tax benefit and returning only that amount to income in post-1983 years.

STATE LAW RESERVES

We have some practical difficulties with the restatement of pre-1984 reserves to the "minimum state law reserves" as suggested by the proposal. The recomputation as suggested would require a contract-by-contract, state-by-state, year-by-year analysis to determine what the state minimums were at various times. While it may be possible to do this, it would be a burdensome administrative task.

Rather than including excess reserves in income over a ten-year period, we suggest that reserves be allowed to run off as benefits are paid and contracts terminated. The proposed minimum state law reserves could be used for contracts issued after 1983, but previously issued contracts could maintain the old reserves until the contracts terminated. On this basis the runoff would be natural, with some kinds of contracts returning reserves to income over a period shorter than ten years (term insurance, perhaps) while other forms of coverage would have reserves returned to income over a longer period (pension retired life reserves, for example). Such a natural runoff approach also has a fairness element to it in that many contracts such as retired life pension contracts were priced with tax effects based on the anticipated durations of the contracts. A ten-year runoff, although not unusual in the tax law, may differ significantly from the assumptions used in setting the contractual price.

CONCLUSIONS

Our specific suggestions for modifying the Subcommittee's approach to measuring ownership differential are summarized in Exhibit 3 together with the tax effects on State Mutual of these suggested modifications.

If adjustments of the nature indicated were included, we believe the Subcommittee's proposal could provide a workable basis to tax us.

EXHIBITS

1. Taxable income for 1982, 1983 and 1984 under 1959 Act, Stopgap and Subcommittee proposal.
2. Illustration of rates of return under tax advantaged and fully taxable investments.
3. Suggested modification of Subcommittee approach to measuring ownership differential.

EXHIBIT 1.—STATE MUTUAL LIFE AND ITS WHOLLY-OWNED LIFE INSURANCE SUBSIDIARY TAXABLE INCOME UNDER SUBCOMMITTEE PROPOSAL, STOPGAP AND THE 1959 ACT[1]

	1982		1983		1984	
	State mutual	SMA life	State mutual	SMA life	State mutual	SMA life
1. G/O before Divs. and FIT per A.S.	73.4	(4.5)	90.0	(9.0)	97.2	(7.0)
2. Subcomm. T.I. before Divs., 25 percent T.I. Adj. and ROE Calc	74.8	(2.6)	99.9	(2.6)	102.9	([2])
3. Divs. to policyholders	68.2	4.0	65.0	6.0	70.0	8.0
4. Line 2 less Line 3	6.6	(6.6)	34.9	(8.6)	32.9	(8.0)
5. "Equity"/Subcom. proposal	365.4	16.6	376.1	14.2	406.8	16.5
6. Return on Equity at 23 percent	84.0	3.8	86.5	3.3	93.7	3.8
7. T.I. under Subcomm. proposal before 25 percent T.I. Adjust.[3]	74.8	(2.6)	86.5	(2.6)	93.7	0
8. 25 percent T.I. Adjustment	18.7		21.6		23.4	
9. T.I. Under Subcomm. proposal	56.1	(2.6)	64.9	(2.6)	70.3	0
10. T.I. under Stopgap	1.6	(7.0)	15.0	(15.9)	18.4	(11.0)
11. T.I. under 1959 Act	31.1	(7.7)	37.2	(18.4)	33.1	(13.4)

[1] Figures are nonconsolidated estimates before credits, without MODCO, and without a possible "upgrade" or "update" program.

[2] Zero due to net operating loss carryover.

[3] Line 2 unless it is greater than Line 6 in which case it is the greater of Line 4 or 6.

EXHIBIT 2

Comparison of after-tax rate of return from current coupon bond to return from discount bond.

The accompanying printouts detail the calculation of after-tax yields obtainable from two investments made to generate $100,000 of value two years hence. These investments would be made to support current offerings of individual deferred annuities.

The first, a utility bond with a 3.25 percent coupon, is purchased at a discount to yield 8.80 percent to maturity. Under current tax law ("Stopgap"), tax would be paid on investment income; increases in reserves and insurance expense items would reduce taxes.

Capital gains would be taxed, but assumption here is that company will always have sufficient portfolio of investments in a capital loss position that gains and losses can be netted.

The second investment, a bank certificate of deposit with a 10.6 percent coupon, is purchased at par.

Under Subcommittee proposal, no tax would be paid on incremental investment income; similarly, no credit could be taken for increases in reserves or insurance expense items.

In both calculations, items shown as investment and insurance expenses include margins; reinvestment rate is assumed to be 10.5 percent in each situation. These calculations show breakeven rates of 9.30 percent and 11.26 percent, which support credited rates of 9 percent and 11 percent, respectively.

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                        *                                  *
                        *             SMA LIFE             *
                        *                                  *
                        *          "3/15" PRODUCT          *
                        *    INDIVIDUAL DEFERRED ANNUITY   *
                        *                                  *
                        ************************************


                              OKLAHOMA GAS & ELECTRIC

                                   FULLY TAXABLE

                   DUE 6-1-85   - YIELD TO MATURITY  8.80000 %

 MATURITY                  CAPITAL GAINS     ORIGINAL      TERM IN     INVEST    REINV
   VALUE        COUPON       TAX RATE         DEPOSIT       MONTHS    EXPENSES    RATE

 $ 100000      3.2500%        0.00%         $  90615         23         20 BP   10.50%



                   NET INV INCOME (AFTER INV EXPENSES)     $      6292
                   TAX ON NET INVESTMENT INCOME            $      2820
                   MEAN RESERVES                           $    100895
                   TAX ON MEAN RESERVES                    $       202
                   INCREASE IN RESERVES                    $     20561
                   TAX ON INCREASE IN RESERVES             $     -9458
                   INSURANCE EXPENSES                      $      2875
                   TAX ON INSURANCE EXPENSES               $     -1322
                   CAPITAL GAINS                           $      9385
                   CAPITAL GAINS TAX                       $         0
                   TOTAL PROFIT                            $         0

ORIGINAL DEPOSIT  $  90615  INTEREST CREDITED  $ 20561   TOTAL VALUE  $ 111176

       BREAKEVEN=                  11.26% EFFECTIVE ANNUAL INTEREST RATE

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                      *                                      *
                      *               SMA LIFE               *
                      *                                      *
                      *            "3/15" PRODUCT            *
                      *     INDIVIDUAL DEFERRED ANNUITY      *
                      *                                      *
                      ****************************************


                                BANK OF AMERICA C.D.

                 DUE 7-22-85  - YIELD TO MATURITY 10.60000 %

MATURITY               CAPITAL GAINS    ORIGINAL     TERM IN    INVEST   REINV
  VALUE      COUPON      TAX RATE        DEPOSIT      MONTHS   EXPENSES   RATE

$ 100000   10.6000%        0.00%       $ 100000       24        20 BP  10.50%

                 NET INV INCOME (AFTER INV EXPENSES)    $     22463
                 TAX ON NET INVESTMENT INCOME           $         0
                 MEAN RESERVES                          $    109731
                 TAX ON MEAN RESERVES                   $         0
                 INCREASE IN RESERVES                   $     19463
                 TAX ON INCREASE IN RESERVES            $         0
                 INSURANCE EXPENSES                     $      3000
                 TAX ON INSURANCE EXPENSES              $         0
                 CAPITAL GAINS                          $         0
                 CAPITAL GAINS TAX                      $         0
                 TOTAL PROFIT                           $         0

ORIGINAL DEPOSIT  $ 100000  INTEREST CREDITED  $ 19463   TOTAL VALUE  $ 119463

                 BREAKEVEN=           9.30% EFFECTIVE ANNUAL INTEREST RATE

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EXHIBIT 3.—SUGGESTED MODIFICATION OF SUBCOMMITTEE OWNERSHIP DIFFERENTIAL

1. Determine stock life company industrywide taxable income for 1984 on the new tax basis, reduced by losses of stock companies in a loss position. Exclude income from prior year "overhang" items (Phase III balances and reserves) which would be penance for prior years and not a 1984 item.

2. Determine stock company industrywide equity on some reasonable basis.

3. Determine mutual industrywide equity on the same basis as 2. above.

4. Impute mutual industrywide taxable income by dividing 1. above by 2. above and multiplying by 3. above.

5. This should produce comparable tax burdens on the equity of the mutual and stock industries.

6. However, the industry average ratio of taxable income on equity cannot fairly be used as a minimum on a company-by-company basis. Those companies less profitable than average would overpay. Stock companies include some with higher than average returns on equity as well as some with negative returns. Mutuals would be similar.

7. Therefore, produce the necessary level of mutual company taxable income by a combination of dividend disallowance and a separate small tax on surplus (for example, a disallowance of 7½ percent of individual nonqualified dividends plus a separate tax of, say, 1 percent of statutory surplus). A dividend disallowance alone is "unfair" to high dividend companies. A surplus based tax alone is "unfair" to low return on equity companies. The two would "balance the unfairness." The two taxes should be separate and not linked to avoid "cliff" problems on the taxable income portion.

8. The tax on surplus should justify full deduction of group and pension dividends and true excess interest. A disallowance of 7½ percent of these items is far too high, but some differential may be theoretically arguable. A modest surplus tax imposes a tax burden on these products in addition to the tax on net gain.

9. We estimate that State Mutual's 1984 tax before credits on this basis without income from the reserve transitional rule would be approximately: $7.3 million on net gain, plus $1.8 million (1 percent of 1984 statutory surplus) for a total tax of $9.1 million.

ADDITIONAL STATEMENT OF W. DOUGLAS BELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, STATE MUTUAL LIFE ASSURANCE COMPANY OF AMERICA

EFFECTS OF COMMON STOCK VALUATION ON SUBCOMMITTEE'S PROPOSED OWNERSHIP DIFFERENTIAL

As we understand the proposal, assets would generally be valued in accordance with NAIC annual statement accounting. Thus, bonds and mortgages would be held at amortized cost; preferred stocks at cost; real estate at cost less depreciation; miscellaneous investment assets at cost; common stock at fair market value (except that common stock of certain subsidiaries would under NAIC rules be held at cost adjusted for the parent's equity in the earnings of the subsidiary).

This method of valuing subsidiaries results in the parent's carrying value being increased by operating gains of the subsidiary including any unrealized gains on common stock held by the subsidiary. Unrealized gains and losses on bonds held by a subsidiary would not be reflected in the parent's carrying value.

Thus, any common stock held by the life insurer and any common stock held by subsidiaries of the life insurer will cause unrealized gains and losses on those common stocks to be reflected in the life insurer's equity base for ownership differential purposes. These fluctuations in market value of the common stock held by the mutual parent or its subsidiaries will be reflected first, within limits, in the Mandatory Securities Valuation Reserve. Larger fluctuations would spill over directly into the surplus of the mutual insurer. Since both MSVR and surplus are components of the Subcommittee's proposed equity base, unrealized fluctuation in value of common stocks of the mutual life insurer or of its subsidiaries will directly be reflected in the base.

A company like ours, whose taxable gain before dividends is above the return on equity base and whose taxable gain after dividends is below the return on equity base (ROE) will not for practical purposes have its tax effected by income and expense items except to the limited extent that they raise or lower the equity base. While we are in this position with predividend gain greater than ROE and postdividend gain less than ROE, our effective tax base is "equity". Any unrealized increases in market values of common stock in our portfolio, whether of General

Motors, IBM or a large subsidiary, will raise our equity base and therefore raise our tax.

Even though this may not be an intended result, this annual tax on unrealized gains makes common stock investments relatively unattractive since other investors bear no tax on an unrealized gain until the stock is sold. The effective rate of tax for us would be approximately 8 percent annually (23 percent times 75 percent times 46 percent). While we might not be overly distressed at selling portfolio stocks such as IBM or General Motors, we do not wish to sell our subsidiaries.

As an example of the perhaps unintended annual tax on unrealized appreciation in common stocks: if we purchased a stock for $1 million in 1983 and it increases in value to $2 million in 1984, this unrealized capital gain of $1 million would generate an $80,000 tax for 1984. Should the stock decline in value in 1985 and be sold by us for $1 million (its original cost) we would have had no real economic gain, but would have paid an $80,000 tax which will not be recoverable.

Since other investment assets are valued at cost for purposes of computing the equity base, we suggest including common stock (or at least common stock of 50 percent owned subsidiaries) in the base at cost rather than at the annual statement carrying value. If included in the computation of the equity base at cost, then stock gains would be includable for tax purposes only upon realization which is the case with all other investors. In addition to the desirability of having common stocks treated on a basis consistent with bonds, mortgages, preferred stocks and real estate, inclusion of common stocks at cost rather than fair market value would eliminate potential compliance complexities in determining fair market values of restricted or nonmarketable stocks (such as subsidiaries). In the alternative, removal of the mandatory securities valuation reserve from the equity base would accomplish somewhat the same result.

Chairman **Stark**. Thank you very much.

The committee will stand in recess until one Member of the majority returns, and I will run and vote. It should not be more than 5 minutes, if you will just be patient.

[Recess.]

Mr. **Guarini** [presiding]. We will proceed. Everybody please be seated.

Mr. Harry D. Garber, the Equitable Life Assurance Society of the United States, please give your presentation, sir.

STATEMENT OF HARRY D. GARBER, SENIOR EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Mr. **Garber**. I am the chief financial officer of the Equitable Life Assurance Society, which in terms of today's comments can be characterized as a giant.

I am pleased to be invited to discuss the proposal of the chairman and Representative Moore.

I would like to start by complimenting the committee on the process, which has been followed in the development of this proposal. As I am the only member of a panel today who actually participated with the staff in the work that has gone on, I would also like to compliment the staff work that has been done. The meetings with industry representatives have been handled in a very professional manner, and it is clear that the staff had worked very hard on this difficult subject. Those of us who have worked with them compliment them on the professionalism that they exhibited in the work.

Mr. **Guarini**. On their behalf, I thank you.

Mr. **Garber**. We made a good start here. This is a very complex subject, and any first proposal is necessarily incomplete in some respects and imperfect in others. But it is a good base to start from. I would like to limit my discussion to two aspects of the proposal.

The first subject I would like to discuss is the level and size of the taxable income minimum that is determined by the rate-of-return approach. I have three points which are covered in more detail in my written presentation. First, the rate of return has been determined by taking the average of three other measures, each of which is, itself, an average result. This average is then used, in effect, as a minimum. From a mathematician's point of view, a process which takes averages and uses them as a minimum causes the ensuing result, or the average, to be more than the computed average. I think that was not intended.

To avoid this something less than the computed average should be used as the minimum.

Second, the rate of return standards are essentially pretax standards. But they are used in this proposal to establish a mutual company minimum base of taxable income. The standards take into account the earnings of corporations in general and of stock life insurance companies, very few of whom actually have a taxable income equal to their pretax income. By using these standards to determine a taxable income level for mutual companies, you have created an artificially high level.

My third point concerns the measurement of the equity base. Mutual companies operate with their statutory surplus as their equity, and this is the only equity they can count on as they become part of the larger financial services industry. It is clear we will need to build that statutory equity along with our business growth, and, therefore, we will be endeavoring to increase statutory equity. The effect of using, for tax purposes, a base that is higher than statutory equity is equivalent to using a higher return on equity rate and that is the way we will look at it.

The main thing I wanted to talk about was trying to bridge the gap that I see here between what the mutual companies are saying and what the committee is hearing in terms of the proposal that has been made.

The first question is the size of the ownership differential. That has been discussed well already.

The second question is equally fundamental. I think Bob Van Fossan was asked at one point whether both are important, and they are.

What the committee has created with this proposal under which most mutual companies being taxed on a computed return on a defined equity base, is a situation where each company will have a fixed tax number, and it will not change much no matter what they do in their operations. Everything we do in business, whether it is the making of a specific investment, deciding how to price products, setting dividend scales, et cetera, requires the evaluation of the tax consequences. But the structure proposed will not give us any way to translate the total tax into the effects on each of the businesses so that these effects can be included in the pricing structure. We will have a total tax number, but, unlike any other corporation, we will have no way of determining what the effects of various actions would be on taxes, what economic benefits or results will ensue from pricing in a certain way, the results that will ensue from setting a certain dividend scale or from deciding to buy a building or invest in a stock or invest in a bond, et cetera; the structure does not allow us to take taxes into account.

Furthermore, it does not, as Mr. Bell said, take account of new business losses. It does not take account of losses on some of the businesses included in the mutual enterprise. This is acutely in my mind now because The Equitable from a tax point of view—is in an operating loss position, but we would have to pay about $100 million in tax under this proposal, and would have essentially 100 percent elimination of dividends.

It occurs because The Equitable and most mutual companies are made up of several different businesses. Each one is operated essentially as a separate mutual company, each one is operated on a financially self-supporting basis, so no business need rely on another one in order to get along. If some of the areas are losing money, and they do not have any dividend payments, a company will still pay dividends to the policyholders in those areas in which it is making money.

In the group insurance business, each contract is operated on the basis of its own experience. Dividends are paid on those contracts with good experience, even though the company is losing money over all.

Under the proposal, a substantial part of a company's dividends may be eliminated because it has losing lines on which no dividends are being paid. In these circumstances, the proposed return on equity approach may result in 20 percent of dividends being disallowed in one year and 60 percent being disallowed in the next without anything in those lines on which dividends are being paid. A company might have exactly the same experience in its participating lines of business, but, because its small group business or its guaranteed interest pension contracts are losing a lot of money, the presumed amount of owner equity dividend would increase substantially.

What the mutual companies are saying is that by having a fixed amount of tax, which largely is independent of their operations, et al, the result is not sensitive enough to their actual operations and results. I am sure you would have precisely the same argument from stock if the companies same approach were to be applied to them.

Chairman STARK. How does that differ from a minimum tax? Ten percent minimum tax, you got a fixed tax the same way?

Mr. GARBER. That is what you think an average result should be and use that as a minimum. If you set a minimum rate at a real low, you have——

Chairman STARK. If you assume that everything else is deductible, the minimum becomes just as much maximum under that theory.

Mr. GARBER. You missed what I said. I said actually the way the business is evolving, we cannot afford to dividend-out because we have to run our business to develop our equity base.

If we are going to compete in the financial services world, we cannot permit our equity bases to run down. We have to build up the equity bases. Dividending-out is really not a practical alternative.

Chairman **Stark**. Beyond the statutory requirement, what do you need the equity basing for?

Mr. **Garber**. For the same reason Citibank needs it.

Chairman **Stark**. My theory is, equity is only there in a bank to protect the depositors or policyholders.

Mr. **Garber**. Right.

Chairman **Stark**. Maybe we will give you insurance and then you could have policyholder insurance and would not need any equity.

Mr. **Garber**. Insurance would cover the liability side of the balance sheet but equity would still be needed for the asset side of the balance sheet.

Mr. **Guarini**. Perhaps we could move on and take up some other questions.

Mr. **Garber**. There is one more comment I would like to make on a related subject.

There have been views expressed today that mutual companies have never paid any taxes on their underwriting gains. Under the 1959 act, the tax for mutual companies was based on their gains from operations—including both investment and underwriting income—except that the dividend deduction was limited to an amount which would not bring the gain from operations below an investment income base. To characterize us as not paying taxes on underwriting gains ignores the basics of the tax formula.

[The prepared statement follows:]

Statement of Harry D. Garber, Senior Executive Vice President and Chief Financial Officer, the Equitable Life Assurance Society of the United States, New York, N.Y.

Mr. Chairman and members of the subcommittee, I am senior Executive Vice President and Chief Financial Officer of The Equitable Life Assurance Society of the United States, a mutual life insurance company and the third largest life insurance company in the United States. I am appearing here today at your invitation to discuss the impact of Chairman Stark and Representative Moore's concept for the taxation of life insurance companies and their products on our company.

I am pleased to have this opportunity to comment on this proposal. Let me first compliment you on the process of open discussion which has been followed by the Select Revenue Measures Subcommittee to date.

The proposal represents an important first step towards a more sensible tax law for life insurance companies. The intention of the proposal, to treat companies alike and to impose a single phase tax based on true economic income, is laudable. However, the present formulation falls short of that goal in an important aspect, namely, in the calculation of the ownership differential. Accordingly, I will concentrate my discussion on this critical element. The defects in the proposal relate to the structure and size of the return on equity element and not to the basic concept itself. I have some thoughts on other areas of the proposal that would be helpful in fleshing out the details. I will not discuss these today, but I would be pleased to discuss them with your staffs at a later date.

SIZE OF MINIMUM RETURN ON EQUITY

My comments will first address some general considerations regarding the size of the proposal's minimum return on equity approach. Next, I will relate some specific examples of situations in which the current design of the proposal would place mutual companies at a significant competitive disadvantage relative to stock companies. Before these specific discussions, it is important to note that, as the consolidation of the financial services industry accelerates, mutual companies are and will continue to be subject to the same pressures to increase and strengthen their capital bases as are stock life insurance companies, banks, and other financial intermediaries. Historically, mutual companies tended to be overcapitalized relative to their volume of business. For most mutual companies in the present competitive environment, this overcapitalization is no longer signficant (if indeed it exists at all) and therefore mutual companies whose only source of capital growth is retained earnings will be obliged to produce after-tax statutory earnings which are commensurate with their future business needs. This corporate need, regardless of other considerations, should assure that most mutual companies, and certainly all mutual companies that wish to function as vital elements of the financial services industry, will be producing significant levels of pre-tax earnings.

The proposed ownership differential reduces the deduction for mutual company policyholder dividends by that portion which purports to represent equity return to policyholders in their capacity as "owners". The objective of this differential is to assure competitive parity between mutual and stock companies. The issue of whether a differential should be applied to a particular company is a question of fact. If the earnings of a mutual company are sufficiently high relative to its capital base, then no ownership differential need be applied because that company is clearly not using policyholder dividends to reduce its pre-tax earnings below those which would be appropriate for a shareholder-owned insurance enterprise. The proposal would recognize this by not requiring any limitation on dividend deductions if the taxable income after full deduction for dividends exceeds a specified level of earnings on equity, a position unlikely to be achieved by most mutual companies.

SIZE OF MINIMUM TAX BASE

With respect to the size of the proposed minimum tax base, I would like to make three points. First, there is a major inconsistency between the determination of a taxable return on equity which should be expected on average to be produced by mutual companies and its use in the proposal, in effect, as a minimum tax base. The approach of the proposal would inevitably produce an aggregate taxable income greater than the "average" return, because some companies will earn more than the "average". To achieve an aggregate taxable income level equal to that which would have resulted if all companies had earned the "average" return rate, any minimum tax level should be lower than that produced by the "average" rate.

My second point deals with the determination of the average rate of return, the application of which determines, in effect, the minimum amount of taxable income. Although the proposal does not describe the method to be used to determine the average rate of return, it appears that the return is intended to be a pre-tax on equity as reported for financial purposes. However, this rate effectively determines the taxable income level for most mutual companies. The recent Joint Committee on Taxation staff reports covering the banking and property and casualty companies demonstrate that very few companies, particularly financial service companies which compete directly with mutual life insurance companies, have a taxable income equal to the pre-tax income reported in their financial statements. Even under this proposal, it seems clear that stock life insurance companies will have considerably less taxable income than reported pre-tax financial statement earnings, although the ratios of taxable to pre-tax reported earnings will undoubtedly be higher than the ratios characteristic of banks and property and causalty companies. In these circumstances, the assumed pre-tax rate of return for determination of minimum mutual company taxable income would place mutual companies at a clear disadvantage relative to competing financial intermediaries. I will discuss the magnitude of this disadvantage later on.

The third point concerns the definition of the equity base to which the rate of return is applied. Mutual companies manage their affairs based on their statutory equity. They will need to maintain statutory equity as a percentage of liabilities at levels comparable to those of competing financial service entities. There is no reason to believe that in the future the relationship of statutory equity to business size measures for comparable kinds of business will differ materially as between mutual and stock companies. In these circumstances, increasing the mutual company equity amount beyond the statutory level for purposes of determining the minimum taxable income is, as a practical matter, equivalent to increasing the minimum rate of return. The precise effects of the proposed adjustments to the equity base cannot be determined until the several adjustment factors are defined in greater detail; in any event, the effect of these adjustments will vary from company to company. However, I believe they will increase the statutory equity base by somewhere between 50 percent and 100 percent. This is equivalent to increasing the 1982 average rate of return from 23 percent to between 34.5 percent and 46 percent.

ILLUSTRATION OF THE MINIMUM TAX

A simple example will illustrate the effect which this mutual company minimum tax structure would have on the competitive position of a mutual company vis-a-vis a stock life or financial intermediary company on a fund accumulation (annuity or pension) account. Assume that both the mutual life insurance company and the competing stock company seek to maintain their regulatory equity base at 5 percent of fund liabilities, that both wish to retain earnings to increase their equity bases by 10 percent per year, and that the stock company wishes to pay shareholder dividends equal to one-third of after-tax earnings.

Under the proposal, the mutual company would have to withhold from its customers between 1.29 percent and 1.56 percent of the funds accumulated to cover capital growth and tax charges.[1] For the stock company, the charge required would depend on the effective tax rate applicable. The results are as follows:

[In percent]

Stock company charge to customer for equity return and taxes

Effective tax rate:	*Percent*
0	0.75
15	.88
30	1.07
46	1.39

Put simply, the tax for a mutual company would be about 1.4 percent, and for a stock company taxed at an effective rate of 30 percent, about 1 percent, enabling the stock company to credit 0.4 percent more on the customer's fund. This clearly shows that unless the stock company had an effective tax rate of approximately 46 percent—and reports of the Joint Committee on Taxation this year certainly show that few, if any, do—the proposed minimum tax base for mutual life insurance companies would produce a result which would make those companies noncompetitive in the area of fund accumulation, including importantly the management of pension plan funds on a guaranteed interest basis. Clearly, the proposed minimum is at too high a level.

OPERATION OF OWNERSHIP DIFFERENTIAL

As proposed, the ownership differential assumes that the disallowed portion of policyholder dividends constitutes a distribution to policyholders as owners, whether it represents 1 percent or 100 percent of dividends. This is obviously an absurd result, because the preponderance of mutual company dividends represents pure and simple price adjustment based on experience. The fact is that there are many circumstances which could cause the taxable income of a stock or a mutual company to fall below the computed return on equity minimum, and it cannot be presumed, as is done in the proposal, that every such difference in the case of a mutual company is due to payments to policyholders as "owners." Let me illustrate three such circumstances. In doing so I might mention that our estimates indicate that the application of the proposal to The Equitable in 1983 would involve elimination as a deduction of almost 100 percent of policyholder dividends. I feel very keenly the need to modify the proposal so that these and other circumstances are handled appropriately.

The first circumstance is the occurrence of operating losses in one or more businesses in a life insurance enterprise. The principles of equity and good business operations require us to pay dividends to policyholders in those participating lines in which we have positive earnings, regardless of the results in other lines. Even within our group insurance line of business, dividends are paid to customers with good experience when there is a loss for the line of business as a whole. Therefore, it is not unusual for a mutual insurance company to experience operating losses in particular lines of business but not change its dividend practices in its other lines and this is The Equitable's situation in 1983. The result under the proposal is that there is an increase in the presumed owner element of the dividend and a consequent reduction in the proportion of the dividends deductible. I believe this is clearly an unintended result. There is no reason why a mutual company's losses for a particular line of operations should have a different tax effect than the otherwise similar losses of a stock company.

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[1] These are before the 25 percent general reduction in taxable income contained in the formula. With this reduction, the mutual company figures are 1.10 percent and 1.29 percent and there will be a corresponding reduction in the stock company effective tax rate.

The second circumstance is rapid new business growth. Such growth involves costs (expenses and fund accumulations) which considerably exceed the premiums received. A stock company is able to obtain a tax deduction equal to these excess first year costs. It will recapture this expense over the lifetime of the policy and the recapture will be taxable income. For a mutual company subject to the minimum tax level, the excess new business growth costs will serve only to reduce the dividend deduction while the subsequent recapture of those expenses will serve to increase the dividends deductible. The dollar tax costs of the stock and mutual companies would become equal over time, but the deferral of taxation for the stock company has a value which can be translated into a lower cost for its customers. We would estimate this benefit to be about 2 percent of premium, not an insignificant additional cost for a mutual company policyholder.

A third circumstance which would create deductions for a stock company, but which would have no tax value for a typical mutual company is tax preference items, such as tax-exempt interest or the excess of accelerated over straight-line depreciation. The stock company would, as would every other taxpayer except mutuals, receive a tax benefit while the increased deduction available to the mutual company would simply reduce the deduction for policyholder dividends.

The proposal would also cause us difficulty in pricing one of our newer products, variable life insurance. This is a product where investment performance in a separate account in excess of the guaranteed rate (apparently deemed to be dividends under this proposal) is applied automatically to purchase additional life insurance. For a male, age 35 at issue, assuming excess earnings of 6 percent, and dividends fully deductible, a face amount of $50,000 at issue would have increased to $83,000 at the end of 20 years. This would be the situation for a stock company. On the other hand, at the end of the 20th year, for the same policy in a mutual company receiving only a 50 percent dividend deduction, the face amount would have risen to only $72,000. To achieve the same level of death benefit at age 55, a 15 percent higher premium would have been required.

For most mutual companies, not present including The Equitable, instead of operating as a minimum tax, the imputed return on equity becomes the tax base and is largely insensitive to changes in income or expense levels of the company. As mentioned above, in the case of Equitable, the deduction for policyholder dividends is entirely eliminated. This compares with a level of deductibility under the 1959 Act ranging from a high of 100 percent to a low of about 45 percent under the 1959 Act (without giving effect to modified coinsurance).

In summary, I believe that the proposal represents a good start towards the common objective of taxing the life insurance industry, and the companies individually, on their economic income. The stock company tax formula, except for the overall 25 percent reduction factor, is largely based on economic income. Further, the objective of the proposal is for mutual companies to be taxed also on economic income and to provide an "overship differential" which would preserve the competitive balance between stock and mutual companies. This aspect of the proposal remains imperfect, however. The use of a rate on equity approach to measure the "equity return" to mutual company policyholders provides a potentially useful conceptual approach. As I have pointed out in my testimony, however, the specifics the proposal overstate the expected rate of return and, because virtually all mutual companies will be taxed on their minimum base, the proposal fails to recognize changes in mutual company economic income. I would be pleased to continue to work with your staffs in an effort to correct these imperfections.

This testimony is not intended to be an exhaustive commentary on the proposal. Numerous other matters of a more or less technical nature need to be addressed, but these matters can be considered when staff is reducing the basic concepts to bill form.

Thank you for inviting me to appear today to assist you in your deliberations.

Mr. GUARINI. Thank you, Mr. Garber.

John J. Creedon, welcome, sir.

STATEMENT OF JOHN J. CREEDON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, METROPOLITAN LIFE INSURANCE CO.

Mr. CREEDON. Thank you, Mr. Guarini.

I very much appreciate the opportunity to testify before this subcommittee. I am separately submitting a more detailed written statement, Mr. Chairman, and I would like to rather briefly summarize this statement in my oral remarks this afternoon.

First, I would like to express my appreciation and that of Metropolitan to the chairman and the subcommittee and staff for the excellent work that has been done in preparing the proposal. While we have a number of concerns about it, we agree with the basic thrust and many of the specifics of the subcommittee's proposal.

This proposal is fundamentally a great improvement in the direction of modernizing the archaic and inequitable system of life insurance taxation created by the 1959 act.

As you know, Metropolitan is a mutual life insurance company. We have approximately 19 million individual policyholders throughout the United States. We insure about 46 million people.

Our concerns, Mr. Chairman, are primarily with three aspects of the proposal, and these are the level of tax, the ownership differential approach, and the treatment of stock subsidiaries of mutual companies. I will discuss each one briefly, but before doing so I would like to enumerate the impact that we feel the proposal would have on Metropolitan Life Insurance Co., and its policyholders.

First, as best as we can guess, and as some of the questions of Mrs. Kennelly and others have indicated in determining some of the estimates of numbers here, there is a lot of uncertainty, but as best we can determine, the level of tax for Metropolitan would increase from approximately $200 million to $400 million. In other words, about a 100-percent increase.

If we were to go to the 1959 act, our estimate is that the tax would be somewhere around $425 million, so that the Stark-Moore proposal would produce a somewhat lower level of tax than under the 1959 act.

Second, if we were a stock life insurance company rather than a mutual company, our tax would be $230 million rather than $400 million. In other words, we would pay $170 million more than a stock company. We would pay 75 percent more taxes than if we were a stock company.

That is the ownership differential as the proposal would develop it, and it is completely out of line, Mr. Chairman, I submit.

Third, the proposal would result in a disallowance of dividends as a deduction from our taxes on the order of about 48 percent, whereas the stock companies would get a 100-percent deduction for policyholder dividends and similar amounts. We would only get a 52 percent deduction. They would get a 100 percent deduction.

This fact could force us to lower our dividends to our policyholders below the level of recent years.

The proposal, Mr. Chairman, would fix our tax on the basis of surplus regardless of financial experience.

If I may depart from my written testimony for a minute, based on the discussions that have taken place here today, it seems to me that this is one of the most important issues that needs to be addressed by the subcommittee and by the staff.

As I understand it, the Stark-Moore proposal proceeds on the assumption that the minimum tax proposed here serves simply to reduce or limit the amount of dividends that a mutual company can deduct. That is one view of it, and theoretically that view is sound. However, the fact of the matter is that in practice, almost every mutual company would pay a tax on surplus.

The minimum tax would become the fixed tax.

The reason that happens is because of the nature of a mutual company and the way it operates.

A mutual company tends to require the payment of a premium that is in excess of the amount that it feels is really necessary to take care of the mortality expenses, and so forth.

It is contemplated from the outset that a dividend will be paid back, and so more money is brought in at the beginning than is contemplated to be necessary.

Part of the reason for doing that is to avoid what happened in very early days, which was to assess policyholders. In other words, we tend to go by class of policy. We want each class of policyholders to be self-supporting. We take in more than we need, and we pay back a dividend. Because of that fact, the minimum tax which the committee has structured does not operate as a minimum tax. The way mutual life insurance companies operate, the minimum tax will act as a fixed tax for most of the companies, and as such it is a tax on surplus; it is a tax on wealth accumulation.

As Doug Bell was indicating earlier, in the case of mutual companies, the surplus tax would go up and down with the stock market, because your surplus is influenced from year to year by the value of your stock, so you would be taxed on unrealized wealth. It becomes a wealth tax, which I don't think the committee really intends.

The proposal, Mr. Chairman, would render Metropolitan Life completely uncompetitive for new products now being sold through various Metropolitan stock subsidiaries, such as Universal Life. Stock subsidiaries of mutuals would be tainted by their mutual company parentage and would also be subject to the surplus tax.

Mr. Chairman, again, the fact of the matter is that stock subsidiaries of mutual companies—at least I can speak for Metropolitan Life Insurance Co., and I would suspect I am speaking for most of the mutual companies—are not operated as mutual companies. They are operated as stock companies. In the pricing of our products we include a factor for return on investment, so that the concern that has been expressed here, that they will operate their stock subsidiaries as mutuals, is simply unfounded.

So these items, Mr. Chairman, summarize the impact of the proposal on Metropolitan.

If I may, I would like to turn to a discussion of the ownership differential in a little more detail.

We recognize that the committee has struggled to develop an ownership differential approach, and it is a very difficult problem. The industry tried to do it for a year and was unable to come up with something that was acceptable to the different companies. We believe that the proposed approach is essentially a tax on the surplus of mutual life insurance companies and is not the way to go.

First, this approach, as it will function in reality, is unrelated to the economic income of the company because it is based on fictional results for any one company.

Second, two companies with identical income, identical dividends, identical operating results, would pay different levels of taxes on different levels of surplus.

Again, if I may depart from the prepared testimony, I will refer back to a comment made by Mr. Beck earlier. He mentioned that in 1981, his company lost about $300 million on its group health business. Let me compare, if I may, Metropolitan and Prudential and the impact on their taxes, as I would understand it.

Right now, Metropolitan has a little higher surplus than Prudential. I am very happy about that. Not everybody might be.

You could take a given year, this year; suppose Metropolitan had the experience that Prudential had a couple of years ago, and we lost $300 million on our group health business, and the net bottom line result was that we had no gain from operations after dividends and Prudential had a $300 million gain from operations after dividends; we would pay a higher tax than Prudential. In other words, we would pay a higher tax than Prudential would pay simply because our surplus is a little better, even though the operating results after dividends were much worse.

I don't know that that is what is intended by the subcommittee.

Similarly, and by contrast, two companies with the same level of surplus would pay the same tax, even though their income, dividends and operating results were very different. A company might be able to deduct 100 percent of its dividends to policyholders or zero percent of its dividends to policyholders, or somewhere in between, based solely on its level of surplus, not on its level of economic income. If they each had the same level of surplus in a given year, they would pay the same tax, even though one company had a gain of $500 million, and the other company had a gain of $200 million.

The tax-on-surplus approach is not sound from an investment policy standpoint. Metropolitan, as well as other similarly situated companies, would not receive the tax benefits from investments in real estate, real estate development, housing and other types of urban and industrial development projects. We would just not get the benefit from that type of investment because our tax would be based on our surplus and not on our overall gain from operations.

We also believe that the tax on surplus would penalize companies if they failed to reduce their surplus. This is a result I am sure the suboommittee does not intend to encourage. The plain fact is that there would be a tax incentive to reduce surplus.

I understand there was a law in Newark some years ago which imposed a tax on surplus and at least one major life insurance company in Newark reduced its surplus to such a dangerous level that it has been struggling to recover from that action since that time.

While I understand the committee might feel that even though it imposes a tax which operates as a tax on surplus, Prudential management should not reduce its surplus to avoid the tax, the Newark tax is a specific illustration of the fact that if there is an economic or tax incentive to reduce surplus, some people are going to move in that direction.

Mr. Chairman, I think that it is not a time for companies to reduce their surplus.

We need the surplus because of asset risks, insurance risks, because of disintermediation risks. That is a big word for saying risks of losses due to policy loan and cash surrenders.

The level of policy loans and cash surrenders of policies is at an all-time high for the industry and these loans and surrenders are causing serious market value losses.

At a time when we have an insolvency of someone like Baldwin-United, a multi-billion dollar company, and have seen the recent precarious experience with the thrift industry, and seen the Comptroller of the Currency and the Federal Reserve dictating a level of 5 percent of assets for banks, they are insisting that they have 5 percent surplus assets in order to continue to function. I do not think that it is the time to provide an economic or tax incentive for companies to reduce their surplus.

We suggest, Mr. Chairman, and again recognizing that this is an extremely difficult proposition, trying to develop an appropriate ownership differential, and Mr. Chapoton talked about a number of approaches in his testimony this morning, we suggest a somewhat different approach, and we recognize that there is no one answer.

It would be an approach based on a dividend differential between stocks and mutuals, which is basically now in stopgap, and which basically was the result of the 1959 Act. At that time, stock companies got a 100-percent deduction of dividends after tax, and mutuals got a 90-percent deduction.

We recognize that there is a problem because the stocks and the mutuals have different views as to what would be an appropriate number. We think there is a rational basis for choosing a dividend differential between stocks and mutuals, and it is related to the actual dividends paid by stock companies with after-tax money. The stock companies are saying, we are paying dividends to our stockholders with before-tax money.

Mutual companies, if they are allowed a 100-percent dividend deduction, are paying dividends to their policyholders with before-tax money.

Look at what the stocks are doing. How much dividends are they paying to their stockholders with after-tax money and translate that into a dividend differential for stocks and mutuals.

We have looked at stock company dividends over a 5-year period. Translate that, since they pay dividends to their stockholders with after-tax money into a dividend disallowance for mutuals. This would allow the mutual companies only a limited dividend deduction and make them pay dividends in excess of that with after-tax money.

This is the essence of the ownership differential between stocks and mutuals, and we believe it would be a rational basis for determining the differential.

It can be identified on the basis of actual dividends paid by stock companies in the last 5 years. It is a figure that is demonstrable, can be obtained from A.M. Best, and the stock dividend after-tax money can be translated into a dividend differential.

This would come up with a dividend differential of somewhere around 7½ percent, but the subcommittee or an economist, or somebody else, could objectively determine what the number should be.

We have submitted, Mr. Chairman, a paper on this issue, and we would be glad to discuss it.

I should note that this proposal, if applied to Metropolitan, for example, would produce a tax of approximately $256 million, compared to $230 million, if we were a stock company, and compared to $400 million under the Stark-Moore proposal, where we would be taxed on surplus.

In order to avoid what I understand has been a concern that some companies might pay larger dividends or take some other action, so that they would pay no Federal income tax, we would agree with the subcommittee's proposal that there be a minimum tax. We think that the minimum tax should be based on a percentage of the gain from operations of the company before dividends. This kind of minimum tax would be a real minimum. It would not be a fixed tax based on surplus. We would apply such a minimum tax to both stocks and mutuals. The level of gain from operations before dividends is such that a tax on that gain would be a real minimum and would be significant.

We believe a 5-percent-gain-from-operations tax as a minimum might be reasonable, but again the level of the tax is something that could be explored, based on the experience of a broad group of companies.

Thus, we believe, Mr. Chairman, that a combination of a disallowance of dividends of somewhere around 7½ percent and a minimum tax on gain from operations before dividends, would avoid all the problems, would avoid all the disadvantages of the tax on surplus approach described before, and would accomplish the central objectives of this committee.

We believe this approach would be simpler, would be more direct, and more equitable, easier to draft and easier to apply, and we strongly recommend it.

I am authorized to say, Mr. Chairman, that a number of other mutual life insurance companies join in this recommendation, including Guardian Life, John Hancock, Mutual of New York, National Life of Vermont, New England Mutual, New York Life, Phoenix Mutual, Pacific Mutual, Provident Mutual, and I think—and I may be wrong—that the mutual companies generally would support an approach along these lines.

Metropolitan Life and these companies would be glad to work further with the subcommittee and the staff in developing this proposal, and we would urge that the subcommittee continue to move forward on a permanent solution for the taxation of the life insurance industry.

I thank you very much for giving me the opportunity to appear before you, and I would be glad to try to answer any questions.

[The prepared statement follows:]

Statement of John J. Creedon, President and Chief Executive Officer, Metropolitan Life Insurance Co.

Mr. Chairman and Members of the Subcommittee, my name is John Creedon. I am President and Chief Executive Officer of Metropolitan Life Insurance Company. I very much appreciate the opportunity to testify before this Subcommittee.

INTRODUCTION

My purpose today is to discuss the proposal before the Subcommittee, bearing in mind its impact on my company, Metropolitan Life. I have also been authorized by other mutual companies to state that they are in agreement with Metropolitan in voicing concern over the use of a surplus tax as a means of imposing an ownership differential against mutuals. These companies include Guardian, Home Life, John Hancock, Mutual of New York, National Life of Vermont, New England Mutual, New York Life, Pacific Mutual, Phoenix Mutual and Provident Mutual.

Metropolitan is a mutual life insurance company. We have approximately 19 million individual policyholders throughout the United States. Altogether we insure about 46 million people. We have no outside group of shareholders. When you tax Metropolitan, you tax our policyholders. Our policyholders are moderate to middle income individuals: The average death benefit payable is about $6,000.

When I testified before this Subcommittee in May, I emphasized that Metropolitan Life is a substantial taxpayer. We have generally tended to pay about 10 percent of total industry taxes. For the five years 1978–1982 (which included the so-called "Mod-Co" years), Metropolitan paid an average of over $200 million annually in taxes. Our 1982 taxes under Stopgap will be about $200 million, which is at least 10 percent of the taxes paid by the industry.

We have calculated our tax under the proposal before the Subcommittee. Under the proposal, Metropolitan would pay a tax of approximately $400 million in 1984. We think this would be an unreasonable tax burden. For example, that amount would represent over 80 percent of our net gain after dividends. With a tax burden that large, we could not maintain our current level of dividends which our policyholders have come to expect.

THE 1959 ACT

Two months ago, we testified that the 1959 Act has proven to be unworkable and unfair. When Congress drafted the 1959 Act, it sought to tax the economic income of life insurance companies. The 1959 Act, however, fell short of that goal. In establishing a multi-phase system of taxation, it had the effect of allowing certain companies, in particular the large, most profitable stock companies, to take full advantage of artificial deductions and deferral of a substantial tax on their profits. Other companies, in the main mutuals, faced limitations which forced them to pay tax on a basis unrelated to their economic income. Overall, as I stated in my testimony in May, the life insurance industry came to pay a much higher level of revenue than the 1959 Act was designed to produce, and mutual companies came to pay a much greater share of the industry tax bill than was appropriate based on the mutuals' share of assets and insurance in force.

For mutual life insurance companies, the 1959 Act created an artificial floor on the deduction of dividends paid to its policyholders. While all companies had to compute gain from operations, the tax formula in the 1959 Act forced virtually all the mutual companies to pay tax on the basis of their taxable investment income. Policyholder dividends, which are refunds of premium overpayments, could be deducted only to the extent that the deduction did not bring taxable income below taxable investment income. When the 1959 Act was passed, mutual companies could effectively deduct roughly 90% of their policyholder dividends. However, as subsequent years saw inflation increase the artificial taxable investment income base and the level of policyholder dividends, the level of deductible dividends dropped from 90 percent to just above 50 percent.

In broader terms, as we moved further away in time from the passage of the 1959 Act, a number of fundamental flaws became apparent which have led most commentators, including Treasury, members of Congress and industry representatives, to conclude that the 1959 Act is inconsistent with sound tax policy. To wit:

Companies with identical income levels would pay different levels of tax with some companies paying tax on their gain from operations, others on less than their gain from operations and still others on taxable investment income which was in excess of its gain from operations.

Companies paying tax on their taxable investment income (i.e., the minimum tax base) could not effectively deduct underwriting expenses. On a marginal basis, policyholder dividends, underwriting expenses and underwriting income had no tax effect. Even a substantial increase in either underwriting profits or underwriting losses would not affect the tax of a Phase I life insurance company.

Similar products were taxed differently, depending on the tax phase of the selling company.

What is needed, then, is a tax law that taxes economic income, does not discriminate unfairly between mutual and stock companies and applies consistent tax treatment to each insurance product regardless of the type of company issuing it.

THE PROPOSED SURPLUS TAX

The proposal currently before the Subcommittee goes a long way toward resolving some of the basic problems of the 1959 Act, particularly in recognizing that a single-phase, gain from operations tax base is required. But the proposal would not tax mutuals on that basis. Instead, in an effort to deal with the very difficult problem of a mutual ownership differential, the proposal produces a separate tax on mutual company surplus, which would be paid by mutuals alone. While constructed as a floor below which mutuals could not deduct policyholder dividends, this surplus tax would become the actual tax base for virtually all mutuals.

We strongly believe that a surplus tax is wrong in concept and unfair in implementation.

A surplus tax on mutuals continues in another form the discredited phase system of taxing life insurance companies. It would impose a tax on mutual companies regardless of whether they experience a profit or suffer a loss. As long as mutual companies are taxed on a basis that has no relation to income, the problems with the artificiality of the 1959 Act phase approach will continue into the future.

If mutual companies are required to pay a tax on hypothetical earnings on surplus, they would pay that fixed level of tax whether or not they have earnings. Two companies with identical income, expenses and policyholder dividends would pay a different level of tax if their surplus levels were different. Two companies with different amounts of income, expenses and policyholder dividends would pay the identical amount of tax if the surplus levels were the same. A surplus tax would tax a company only on the basis of its size, without considering whether the company has gains or losses. While mutual companies will be paying a fixed level of tax, stock companies would be taxed based upon economic income.

The proposed tax would artificially inhibit the growth of our surplus at a time when we need the strength of surplus funds to cushion ourselves against the uncertainties of a volatile economy and dramatic changes in the financial services industry. It would put many mutuals in the difficult dilemma of maintaining adequate surplus and paying high taxes or reducing surplus and lowering taxes.

Against the backdrop of Baldwin-United, the recent experience of thrift institutions and the recent recommendation of the Federal Reserve and the Comptroller of the Currency concerning minimum primary capital for major banks, this is not the time to provide an economic incentive for surplus reduction for any financial institution.

What would be the practical consequences of the proposed surplus tax? Let me talk about it in terms of its likely effect on Metropolitan.

Under the proposal, if Metropolitan were taxed on the gain from operations base is applicable to stock companies, the tax on our gain from operations would be about $230 million. The surplus tax, however, means that Metropolitan's tax will be about $400 million. For us, this equates to the disallowance of a deduction for close to 48 percent of our dividends and similar amounts returned to policyholders. We understand that the average disallowance for mutuals will be about 64 percent, that a number of mutuals will lose all their policyholder dividend deductions and that the surplus tax will be especially burdensome on smaller companies since they tend to have relatively higher surplus ratios.

The proposal would also affect Metropolitan adversely in many other ways. Of significance is the area of investments. The surplus tax proposal would mean that mutual life insurance companies paying a fixed level of tax would lose any benefit from tax incentives designed to promote economic growth. Our company has substantial sums invested in ownership of real estate of different kinds—apartment houses, office buildings, shopping centers, warehouses, hotels and other developments. These investments would become much less attractive and we would likely curtail our new investments and reevaluate our existing ones. Metropolitan has over $1.8 billion of equity capital invested in urban development. We had scheduled substantial investments in energy related projects over the next five years. The tax advantage of such investments would be lost to us since our tax would be grounded in a purely theoretical tax on our surplus.

Perhaps of even greater concern is the impact that the proposal would have on the financial management of mutual life insurance companies. Prudent management, especially in these volatile times, dictates that we provide some measure of surplus for a variety of contingencies.

In the case of Metropolitan, we have a surplus of about $2.5 billion. We also have over $800 million in our mandatory security reserve and other similar reserves, which we do not believe represents equity but rather is necessary to protect against possible investment losses. In absolute terms, that's a huge amount of money. But what does it protect against? First of all, we have assets of $57 billion so that the surplus is less than 5 percent of our assets. I should note that this $57 billion represents the book value of our assets. The market value of these assets would be considerably below $57 billion, so that if these assets were carried at market value our surplus would be greatly diminished.

Our $57 billion of assets are invested in a wide spectrum of investments. Does it stretch the imagination too much to contemplate a substantial loss on such assets, especially in view of the difference of market and book value which I just mentioned? Further, we have more than $400 billion of life insurance inforce plus other substantial liabilities aggregating billions of dollars—in the private pension area especially. Looking at the relative sizes—$2.5 billion of surplus, $57 billion of assets and $400 billion of insurance—we could easily envision scenarios where our entire surplus would be needed to protect the solvency of the company.

Another great risk which surplus protects against is the risk of financial disintermediation. Some people would have everybody buy term and invest the rest outside the insurance industry. Higher interest rates encourages that approach—in part because life insurance is already subject to more tax than many other forms of investment. The life insurance industry has been experiencing the highest level of policy surrender in its history and policy loans have just recently receded from their high point. These results are equivalent to what the thrifts have experienced. Remember that if we have to liquidate assets to meet surrenders and loans, these assets would be liquidated at market value and would surely cause significant reductions in company surplus. If we had another surge of very high interest rates, many in our industry might be coming to Congress for help and a rash of insolvencies under state guaranteed laws (which require the solvent companies to pay the policyholders of insolvents) could have a serious domino effect.

In the current environment, giving companies an economic incentive to deplete surplus seems most unwise.

The surplus tax would not only apply to mutuals but to stock life insurance companies that are subsidiaries of mutuals. Thus, a company created and operated as a stock company under law would be taxed as though it were a mutual, by virtue of its mutual parentage. This would be a departure from accepted tax principles.

Today many stock life insurance companies are wholly owned by large industrial and financial conglomerates and operate as part of a single competitive entity. Yet, it has not been suggested that we attribute to these stock life companies the tax status of their non-life parents.

It has been suggested that mutual companies operate their subsidiaries as mutuals. We know of no evidence of this. To the contrary, these subsidiaries (including our own) are operated as stock companies with a view to providing a return to their parent mutual companies. The tax law should respect their legal form and substance.

The surplus tax proposed would put Metropolitan and other mutual companies in an impossible competitive position. This is dramatically illustrated when we compare the taxation of two similar universal life contracts. One is issued by a stock insurance company or one of its subsidiaries or by a stock insurance subsidiary of a bank. The other is issued by Metropolitan or one of its stock subsidiaries. The stock company or its subsidiary would be allowed a deduction for 100 percent of the interest returned to its policyholders. The deduction available to Metropolitan or its subsidiary would be restricted to about 52 percent. In the highly competitive environment surrounding the marketing of new products, there is no way that Metropolitan could effectively compete. Further, there would be mutual companies worse off than Metropolitan, some of whom would be unable to deduct any interest.

Is the public interest served by a tax law precluding mutual life insurance companies from effectively marketing new life insurance products while opening the way for banks and securities firms to sell these same products at a tremendous competitive advantage?

Let's look at what may be the most unfortunate consequence of the surplus tax: if a stock company suffers a loss from operations, it will pay no tax. Metropolitan could have a loss from operations in 1984 and still have to pay $400 million in taxes. For example, Metropolitan and Prudential have roughly the same level of surplus. But our economic experience is not always the same, and neither is our tax liability. In 1980, Prudential experienced $300 million in health insurance losses. If they were to experience a similar loss in 1984, the loss would not affect their tax. Despite the fact that Prudential was considerably less profitable than Metropolitan, both would pay roughly the same amount of tax based on surplus levels. This just does not seem sensible to us.

There is a clear distinction between insurance companies who become policyholders of mutual life insurance companies and investors who buy and sell shares in stock life insurance companies. There is a serious question as to why the tax system should require the policyholders of our mutual companies in effect to subsidize those large institutions and individuals investing in stock companies. Beyond this, however, assuming this subcommittee believes that some differential against mutuals in appropriate, the most harmful way to structure it is through a tax like the one proposed on mutual surplus.

In summary, like the 1959 Act, the proposal before this Subcommittee has three fundamental flaws:

Companies with identical income levels could pay different levels of tax with some companies paying tax on gain from operations and others on more than gain from operations.

Companies paying tax on the surplus tax base will not be able to effectively deduct underwriting or investment expenses. On a marginal basis, policyholder dividends, underwriting expenses and underwriting income will have no tax effect. Even a substantial increase in either underwriting profits or underwriting losses would not affect the tax of a mutual company.

Because of the minimum tax, some products such as variable or universal life, cannot be sold competitively by mutual insurance companies.

MODIFY THE OWNERSHIP DIFFERENTIAL MECHANISM

We support a tax law that would be based on a straightforward, single-phase system:

1. Adopt the basic gain from operations structure in the Stark-Moore proposal for all companies.
2. Provide an "ownership differential," to the extent necessary, grounded in stock company dividends to shareholders, and expressed as a disallowance of a percentage of mutual company dividends in determining their gain from operations.
3. Provide a true minimum tax grounded in a percentage of gain from operations before deduction of dividends and excess interest paid to policyholders.

THE "OWNERSHIP DIFFERENTIAL"

As we have said, we do not agree that an ownership differential is fair or justified. However, the stock life insurance companies have expressed concern that dividends paid to policyholders include a portion which is to be construed as a pre-tax stockholder dividend, which ought to be taxed on a basis which would make the mutuals comparable to stock companies.

If a differential is to be included in the tax law, the determination of the appropriate amount should follow logically from a study of the after-tax dividends to shareholders actually paid by stock life insurance companies, since this is the essence of the ownership differential between stocks and mutuals. If mutuals had a dividend allowance comparable to the level of dividends paid by stock companies to their stockholders, we believe this would be a rational basis for the ownership differential. Such an amount can be identified.

Metropolitan has produced a study determining that amount, based upon actual dividends paid by stock companies in the last 5 years and using figures reported by the A. M. Best publications.

Under our method, the dividends paid to stockholders with after-tax money can be translated into a dividend differential. The approach used comes up with an average dividend differential of approximately 7½ percent. We have attached a copy of Metropolitan's study to this document.

THE QUESTION OF A MINIMUM TAX

We understand that the proposal wherein the separate imputed return on mutual equity would serve as both a differential and, as a practical matter, as a tax floor for mutuals, stems from concern that dividends might otherwise be subject to manipulation, or overpayment to eliminate all taxes. For the following reasons, we do not believe that this concern is well-founded:

1. In the worst case, an insurer would overpay dividends for a limited period of time only, before threatening itself with insolvency.

2. Although dividends are not legally guaranteed, policyholders, expect, and competition requires, that dividend levels be maintained at levels appropriate to the economic conditions of the company, and not be subject to the severe and arbitrary fluctuations inherent in any largescale manipulation solely for tax purposes.

3. The payment of appropriate dividends on participating business is mandated by state insurance law.

Nevertheless, if the Subcommittee wishes to respond to that concern, a true minimum tax should be imposed. Moreover, since the concern is that a tax on gain from operations would be nullified by manipulation, it would seem appropriate to express any minimum as a simple percentage of gain from operations, below which taxes may not be reduced on account of dividends. We are suggesting 5 percent.

Note that the ownership differential has been treated separately by a disallowance of dividends. Thus the minimum tax should be a simple floor, expressed as a percentage of the economic income being taxed. Since this is not related to the ownership differential, it should be applied to stock companies, as well as mutuals.

CONCLUSION

Based on our analysis, we urge that you reject the proposed tax on surplus as the means of providing an ownership differential. Instead, we would tax all companies, mutual and stock, on their gain from operations as developed by the Subcommittee, but permit stocks a deduction of 100 percent of dividends while giving mutuals a deduction of no less than 92½ percent. Further, to assure that there would be no manipulation of dividends that could result in an unwarranted minimizing of tax, we would propose a real minimum tax which would be grounded in mutual companies' gain from operations. This would be a minimum tax expressed as a percentage of the company's gain from operations prior to any deduction for policyholder dividends. This minimum could apply to all insurance companies.

Metropolitan Life and the companies that have endorsed this statement would be glad to work futher with the Subcommittee and the staff in developing this modification and we would hope and urge that the Subcommittee continue to move on to a permanent solution for the taxation of the life insurance industry.

LIFE INSURANCE COMPANY TAXATION MUTUAL/STOCK DIFFERENTIAL

I. INTRODUCTION

There was considerable testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee about whether "competitive balance" requires that an "ownership differential" be imposed against mutual companies. The "balance" issue is not new and stems form differences between stock and mutual companies engaged in the life insurance business. Stock companies are ordinary corporation owned by their shareholders. Their policyholders are simply customers. Mutual companies are cooperative organizations formed with a view to providing insurance to policyholders at cost. Their contracts are participating in nature and through "policyholder dividends" they return premiums to policyholders which experience determines are in excess of what is needed. Mutual companies have no separate class of shareholders.

At the time of the 1959 Act, mutuals controlled the lion's share of the life insurance business. They had about 75 percent of industry assets and 63 percent of the insurance in force. The "competitive balance" controversy centered about the tax treatment of mutual policyholder dividends. Mutuals argued for a full deduction viewing policyholder dividends as price adjustments. Stocks argued that a full deduction would minimize mutual taxes and put stocks at a competitive disadvantage. the result was the 1959 Act phase system which required the separate calculation of "taxable investment income" and provided that policyholder dividends could not reduce taxable income below that amount. To assure even more "balance" the 1959 Act imposed additional differentials in the form of scattered extra tax benefits for some stock companies including deferral of taxes on half of underwriting gain and special deductions for non-participating contracts and group life and accident and health contracts.

With the advent of Stopgap which liberalized the deduction for policyholder dividends, another differential appeared in that stocks were allowed to deduct a minimum of 85 percent of policyholder dividends while mutuals could deduct only 77½ percent.

In testimony before the Subcommittee on Select Revenue Measures, Treasury Assistant Secretary Chapoton outlined a conceptual framework for a new tax law which would do away with the present phase system and eliminate deferrals and special deductions now available to certain stock companies. Instead, there would be one tax base for all life companies which would include all economic income with no distinction based on investment or underwriting income. A full deduction would be allowed all companies for amounts credited to policyholders. Mutuals, however, would be denied a deduction for the portion of their policyholder dividends representing a return on equity similar to that paid by a stock company to a shareholder. The method by which this "return on equity" portion of mutual policyholder dividends would be ascertained was left open.

This memorandum examines the propriety of treating mutual policyholders as shareholders and denying deductions for policyholder dividends at the company level on the basis that a portion represents a return on shareholder equity. It concludes that mutual policyholder dividends are different than shareholder dividends and that tax treatment analogous to shareholder dividends is not warranted. This memorandum goes on, however, to show that if similar treatment is mandated, i.e., a portion of policyholder dividends is treated as a non-deductible shareholder dividend, that portion should be very small.

II. TREATING A PORTION OF POLICYHOLDER DIVIDENDS AS NON-DEDUCTIBLE SHAREHOLDER DIVIDENDS ON THE PREMISE THAT POLICYHOLDERS ARE MUTUAL COMPANY OWNERS IS NOT JUSTIFIED

A mutual insurance company has no shareholders, who would be the legal owners of a stock corporation. It has policyholders who are characterized as "members" of the corporation. Our common law leads us to assume that wherever there is property there must be an "owner". The most likely candidates, if there are no shareholders, would be the policyholders. But, courts have held that the relationship between the policyholder and the company is contractual, that of creditor and debtor. One court characterized the status of the policyholder in a mutual company as follows:

"As an incident of membership . . . the policyholder acquires certain specified proprietary interests therein, but, apart from these the relationship is not of a fiduciary nature nor is the policyholder in any sense a partner of the corporation, and the relationship between the company and its policyholder is essentially that of debtor and creditor measured by the contractual terms of the policy".[1]

The rights of a policyholder of a mutual company are quite clearly defined. Some are like shareholder rights and some are different, but there are all prescribed in the law which creates a relationship that is not that of a shareholder or an owner on one hand or simply a creditor or consumer on the other. What is created is something special and unique.

A stockholder has an equity interest in the traditional business corporation. This is a proprietary interect which can be bought and sole. The stockholder hopes for and expects not only a reasonable return on his equity but also the possibility of capital appreciation. The stock may be traded on a national exchange; if so, the owner may watch, perhaps on a daily basis, the fortunes of his stock. The stockholder may or may not be a customer of the corporation as well. If so, his interest as a customer is completely different from his interest as a stockholder.

The policyholder of a mutual life insurance company is essentially a customer. He has a contract with the company that spells out certain rights. He has the right to the payment of money upon the happening of certain events-and a right to share in policy dividends. His expectation is that his contract will be performed. When the contract has been performed, his rights terminate. No "ownership" right passes to his estate. His interest cannot be traded in any kind of a market.

The policyholders cannot, as shareholders can, vote to liquidate the corporation and divide up the surplus. If a mutual life insurance company is liquidated because it is apparently insolvent and it turns out, contrary to expectations, that there is a surplus, then the New York law provides for the policyholders to share it. This does not denote ownership but merely a legislative judgment as to an equitable way of dealing with the surplus in this situation. The Wisconsin law, under the same circumstances, provides that policyholders may receive only a limited amount with the balance of any surplus going to the state treasury to the credit of a state school fund.[2]

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[1] Fidelity & Casualty Co. of New York v. Metropolitan Life Ins. Co., 42 Misc. 2d 616, 248 N.Y.S. 2d 559 (1964).

[2] Wisconsin Insurance Code § 645.72.

There is no outside precedent for a mutual/stock differential grounded in purported ownership of the mutual company. Until the 1959 Act, stock and mutual life insurance companies competed without a differential. Stocks and mutuals compete in a number of industries including banking and property and liability insurance. The tax law does not impose a differential in any of these areas. For example, a mutual savings bank fully deducts dividends (interest on deposits) paid to depositors on the same basis as a stock savings bank deducts interest it pays its depositors. No differential is imposed to equate mutual depositors to shareholders. Similarly, mutual property and liability insurance companies are entitled to fully deduct their policyholder dividends. Again no differential is imposed.

Proponents of a differential have argued that viewed from a conceptual standpoint, a mutual policyholder is both a customer and a supplier of capital. From a practical standpoint, however, there seems little doubt that the mutual policyholder views himself as no more than a customer in purchasing insurance. In choosing between a stock or mutual company the prospective policyholder examines the products, service, liability and cost comparisons with respect to companies. It is safe to say that in purchasing a mutual policy, the policyholder does not equate his purchase to a purchase of a share of stock any more than a depositor in a mutual savings bank equates his deposit to a purchase of bank stock.

Unlike a shareholder, a policyholder cannot trade his interest nor pass it on to his heirs. In fact, the insured's "equity" interest ends at death and his beneficiaries receive the same thing the stock company beneficiary receives—the face value of the insurance.

The Internal Revenue Service has recognized the de minimis value of the "shareholder equity" in a mutual organization. In Revenue Ruling 80-105, 1980-1 C.B. 78, the Service, in ruling that the distribution of warrants to purchase the stock to the depositors of a demutualized bank qualifed as a reorganization order Section 368(a)(1)(f) of the Code, held that the equity interest were "more nominal than real".

III. MUTUAL COMPANIES PAY THE EQUIVALENT OF THE CORPORATE TAX IMPOSED ON STOCK COMPANIES PAYING NONDEDUCTIBLE SHAREHOLDER DIVIDENDS

Stock companies receive a portion of their risk capital through shareholder contributions. These contributions are not included in company income. Mutual companies receive their "risk capital" through additional margins incorporated in policyholder premiums. These amounts are taxable as premium income of the company.

Thus, if both a stock and a mutual receive $100 "capital", the stock company will receive a full $100 capital contribution without a tax while the mutual company will pay a tax of $46 and will have only $54 in "risk capital".

Assuming that the risk capital generates 10 percent in profits the stock company would be able to pay its shareholders $5.40 after paying a tax of $4.60. The mutual company, assuming it can fully deduct policyholder dividends, would be in a position to pay the same $5.40 dividend to its policyholders.

This important benefit to stock companies—receiving risk capital tax free while mutual companies are taxed on such capital—has gone unmentioned in some of the arguments for a large differential. This may account for differences in the size of the differential.

If a portion of mutual company's dividends to policyholders should be non-deductible as "shareholder dividends", similarly a portion of premiums should be excluded from income as paid in capital.

IV. A DIFFERENTIAL GROUNDED IN A POLICYHOLDER TAX ON DIVIDENDS RECEIVED IS NOT WARRANTED

Since the rights of a policyholder fall far short of the rights of a shareholder, similar tax treatment is not required. However, assuming arguendo that a portion of a policyholder dividend is a return on equity deemed taxable to the policyholder, the proxy tax would be an insignificant amount. The combination of mutual company policyholders' lower and middle income brackets and the tax laws exclusion for shareholder dividends, would result in little or no individual tax. (Over 85 percent of taxpayers have a totally unused dividend exclusion.) Group contractholders bear a tax under present law on dividends paid to them on their contracts.

V. ANY DIFFERENTIAL GROUNDED IN TREATING PORTIONS OF POLICYHOLDER DIVIDENDS AS NON-DEDUCTIBLE SHAREHOLDER DIVIDENDS WOULD BE MINIMAL

Assuming that a differential should be imposed to reflect the equity ownership of mutual policyholders, the differential must also take into account the amounts of paid in capital and surplus which should be received tax free. Such a differential would equate to a disallowance of no more than 7.5 percent of policyholder dividends and should in fact be considerably smaller.

As previously developed, no "differential" is warranted. Assistant Secretary Chapoton's testimony, however, states that mutual company policyholder dividends should not be deductible to the extent they represent a "dividend type return on equity". This implies that Treasury views the mutual company policyholders as the equity owners of the company. Any such "equity" ownership, if it exists, would appear to be represented by the mutual company's surplus—the excess of its assets over its liabilities, including its reserves. To the extent there is "equity" in a mutual company, the company's surplus would seem to be the only reasonable measure of it.

There is no generally accepted standard to determine how much, if any, of policyholder dividends could be characterized as a return on this equity. The only available standard is the amount of shareholder dividends paid by stock companies in relation to the "equity" of such companies—that is, the capital and surplus of the stock companies. Since mutual companies and stock companies compete with one another head to head, it must be assumed that they both incur the same general cost of capital.

If a single phase tax on all gain from operations is adopted as we propose, a stock company will be taxable at the corporate level, just as any other taxable corporation, on an amount equal to its total earnings before tax, i.e., its gain from operations. This amount, after payment of the corporate tax, will either be paid out to shareholders as a dividend or will represent retained earnings added to the stock company's surplus. To achieve the same result for a mutual company, assuming for sake of argument that part of policyholder dividends should be treated as a "dividend type return on equity", it is necessary only to deny a deduction for that part of policyholder dividends that is comparable to shareholder dividends paid by stock companies. The mutual company will then also be taxable at the corporate level on an amount (gain from operations representings earning before tax) which, after payment of the corporate tax, will either have been paid out to the "owners" as a dividend-type return on equity or will represent retained earnings.

In other words, the objective should not be to tax at the corporate level an amount representing an imputed return on capital and surplus. A tax on all gain from operations will reach the actual return on capital and surplus realized individually by each company, if, in the case of mutual companies, (assuming such enterprises are profit-seeking), the portion of policyholder dividends representing an amount comparable to shareholder dividends of stock companies is made non-deductible. No arbitrary imputation is required. Mutual companies and stock companies will receive equal treatment, assuming Treasury's basic hypothesis is correct that part of policyholder dividends represents a return on equity to the owners of mutual companies.[3]

In equating mutuals to stock companies, mutuals should be deemed to pay their policyholders as a return on equity (surplus) an amount no greater than the amount paid by stock companies as shareholder dividends and should be entitled to receive credit for at least an equal amount of paid in capital and surplus.

Using the best available industry-wide data, furnished by A.M. Best Co., we have made an analysis of stock company shareholder dividends as a percentage of surplus of the stock companies. We have also analyzed stock company paid in capital and paid in surplus as a percentage of surplus during the period. It is questional whether mutual companies should be imputed the experience of more profitable stock companies.[4] However, mutuals should not be imputed returns greater than the stocks. The analysis below shows that over the past five years stock companies annually received on average an amount equal to 4 percent of surplus tax free as capital contributions while they paid on average an amount equal to 7 percent of surplus in shareholder dividends. Thus, the maximum differential should not exceed 3 percent of surplus of mutual companies.

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[3] Further, any proposal that mutual companies be denied a deduction for a greater return on equity than is paid out by the stock companies would totally ignore the testimony of Professor Nielson in the hearings. She concluded, by comparing an imputed return on surplus of mutual companies to actual additions to surplus of the companies from gain from operations after policyholder dividends (e.g., economic income), that a gain from operations tax base would fully tax any policyholder equity investment.

[4] In recent years many stock companies have been realizing substantial profits from non-participating contracts written years ago.

ANALYSIS OF STOCK COMPANY SHAREHOLDER DIVIDENDS AND PAID-IN CAPITAL AND SURPLUS

[Dollars in millions]

	1977	1978	1979	1980	1981
Surplus	$14,467	$16,225	$18,402	$20,944	$22,980
Paid-In	$342	$440	$850	$626	$1,649
Percent paid-in	2.4	2.7	4.6	3.0	7.2
Shareholder dividends	$848	$1,040	$1,491	$1,503	$1,657
Percent of surplus	5.9	6.4	8.1	7.2	7.2

The average of 3 percent of surplus, can be equated to a percentage of policyholder dividends as follows:

ANALYSIS OF MUTUAL COMPANY SURPLUS AND DIVIDENDS

[Dollars in millions]

	1977	1978	1979	1980	1981
Surplus	$9,614	$10,733	$12,278	$14,248	$15,091
3 percent	$288	$322	$368	$427	$452
Policyholder dividends	$5,367	$5,814	$6,438	$6,696	$7,411
Percent of dividends	5.4	5.5	5.7	6.4	6.1
5-year average (percent)					5.8

We believe that any differential should take into account the actual shareholder dividends paid by stock companies and not a greater imputed return. Thus, a differential based upon an imputed return of 3 percent of surplus would adequately take into account an imputed return to shareholders. This approach is confirmed by a second analysis which would "mutualize" the stocks for tax purposes. The differential under this analysis can be quantified by putting stocks and mutuals on the same tax base—gain from operations—and determining the effect of including capital and surplus contributions in the income of stock companies and of deducting shareholder dividends as if they were policyholder dividends. An effective tax rate on this base for stocks could be applied to mutuals to determine the maximum differential.

[Dollars in millions]

	1977	1978	1979	1980	1981
STOCKS					
1. Gain from operations	$3,149	$3,933	$4,423	$4,361	$3,951
2. Tax at .46	1,449	1,909	2,034	2,006	1,816
3. Paid-in	342	440	850	626	1,649
4. Shareholder dividend	848	1,040	1,491	1,503	1,657
5. Modified tax base	2,643	3,333	3,782	3,484	3,943
6. Effective tax rate 2/5 (percent)	54.8	54.3	53.8	57.6	46.1
7. Average effective rate 1977–81 (percent)					53.0
MUTUALS					
1. Gain from operations	$2,725	$3,302	$3,659	$3,245	$2,423
2. Tax at 46 percent	1,254	1,519	1,683	1,493	1,115
3. Tax at 53 percent	1,444	1,750	1,939	1,720	1,284
4. Difference	$190	$231	$256	$227	$169
5. 4/.46 (amount of dividends to be disallowed)	413	502	557	493	367

	1977	1978	1979	1980	1981
6. Total policyholder dividends of mutuals	5,367	5,814	6,438	6,696	7,411
7. Percent disallowed 5/6	7.7	8.6	8.7	7.3	5.0
8. Average disallowance (percent)					7.46

The average policyholder dividend disallowance under this method is 7.5 percent while the disallowance under our first method is about 5.8 percent.

VI. CONCLUSION

In sum, while we do not agree with the premise that a portion of mutual policyholder dividends should be treated as nondeductible shareholder dividends, the result as demonstrated would be disallowance of policyholder dividends of no more than 5.8–7.5 percent.

These percentages would represent the outer limits of any policyholder dividend disallowance or "differential". Since this differential equalizes the taxes of stocks and mutuals, no other differential in the form of other tax benefits or deferrals would be justified. In addition, since the above analysis is grounded in equating the rights of policyholders with those of shareholders and since mutuals policyholders possess far less incidents of "ownership" than stock company shareholders, the differential should be discounted accordingly. Any permanent differential should also take into account current trends in the insurance industry, specifically increasing sales of universal life and other "quasi-participating" contracts by stock companies. Because these contracts are participating in nature and involve a reduced risk and consequent lower return for stock company shareholders, the differential to the extent attributable to them will be considerably less.

Metropolitan Life Insurance Co.,
New York, N.Y., July 28, 1983.

Hon. Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, House of Representatives, Washington, D.C.

Dear Chairman Stark: The attached statement is submitted in behalf of The Guardian Life Insurance Company of America, Home Life Insurance Company, John Hancock Mutual Life Insurance Company, Metropolitan Life Insurance Company, The Mutual Life Insurance Company of New York, National Life Insurance Company, New England Mutual Life Insurance Company, New York Life Insurance Company, Pacific Mutual Life Insurance Company, Penn Mutual Life Insurance Company, Phoenix Mutual Life Insurance Company and Provident Mutual Life Insurance Company of Philadelphia.

It addresses the return on equity concept used to measure the mutual ownership differential in the Life Insurance Company Tax Proposal under consideration by your Subcommittee.

We request that this statement be filed as part of the record.

Sincerely,

John J. Creedon.

Attachment.

Statement Before the Subcommittee on Select Revenue Measures of the Ways and Means Committee

Submitted on behalf of:

The Guardian Life Insurance Company of America; Home Life Insurance Company; John Hancock Mutual Life Insurance Company; Metropolitan Life Insurance Company; The Mutual Life Insurance Company of New York; National Life Insurance Company; New England Mutual Life Insurance Company; New York Life Insurance Company; Pacific Mutual Life Insurance Company; Penn Mutual Life Insurance Company; Phoenix Mutual Life Insurance Company; and Provident Mutual Life Insurance Company of Philadelphia.

This statement, submitted on behalf of the above mutual life insurance companies, is limited to addressing the proposal concerning the so-called ownership differential set forth in the release dated July 14, 1983, "Description of Life Insurance Income Tax Proposal." By way of this statement, we wish to convey our deep concern over the size and structure of the proposed "minimum" tax on mutual insurance companies.

Comments on the treatment of stock subsidiaries of mutual companies and other issues, while also of major concern to these companies, have been addressed in other submissions by individual companies and industry groups.

At the Subcommittee's May hearings, members of this group argued that the 1959 Act was a disaster. It was urged that stock and mutual companies should be taxed on their gain from operations, that the 1959 Act phase system should be abandoned, that artificial deductions and deferrals should be eliminated and that amounts paid to policyholders should be deductible.

In its broad outline the proposal appears to move in the direction urged. The proposal develops a straightforward gain from operations tax on economic income. However, as a practical matter, this base is only made available to stock companies. With a view to imposing an "ownership differential" against mutuals, the proposal constructs a separate base grounded in the application of earnings rates unrelated to mutuals to an expanded mutual company surplus. This surplus tax would become the tax base for virtually all mutuals and would produce taxes far in excess of the taxes mutuals would pay if we were taxed on the same basis as stock companies. No sound tax policy supports such clear and unprecedented discrimination against mutual life insurance companies and their policyholders.

We suggest several clear reasons for our opposition to the suggested mechanism for determining ownership differential.

First, a surplus tax attributes a tax to fictitious income.

This is not a tax on the economic income of the affected companies. As proposed, it will apply to almost all mutual insurers regardless of actual operating results.

Use of interest on surplus as a tax base presumes that every mutual company will return income to its owners irrespective of its financial operation's results. It incorrectly assumes that the return of equity is always present even if a mutual company is unable to pay any return of excess premium to its customers and, thereby, is uncompetitive with stock companies and other mutuals.

A clear example of this may be seen if one examines two hypothetical companies with exactly the same financial results, including policyholder dividends, but having different amounts of surplus. In this situation, the company with higher surplus pays a larger tax. The return on equity approach makes the arbitrary assumption that the company having higher surplus will automatically provide a lower return of excess premium to its customers. There is no basis for such an assumption in that there is no proportionate or other relationship between the amount of surplus and the size of a customer's rebate.

Furthermore, one may question whether the form of this tax indicates that it should be construed as an excise tax on mutual insurers, rather than an income tax.

A tax on surplus would be contrary to public policy, as expressed in the regulatory concern for the solvency of insurers and protection of policyholders.

Maintenance of appropriate surplus is an important regulatory and management concern of all insurers. Particularly in unsettled economic times, management must determine appropriate levels of surplus with several considerations in mind.

The level must be sufficient to protect against the volatility of the particular types of business in which the company is engaged.

The level of surplus relative to assets is related to the size of the company.

The level is related to the interest rate environment, and possible investment losses created by policy loans and surrenders requiring the sale of securities with below-market yields.

The level is related to the nature of the risks involved in types of investments in a company's portfolio.

The level is related to the company's need for growth and diversification since a mutual cannot raise equity capital.

A tax on surplus would artifically inhibit the growth of surplus at a time when companies need the strength of surplus funds to cushion themselves against the uncertainties of a volatile economy and dramatic changes in the financial services industry.

Against the backdrop of Baldwin-United, Seafirst, and Penn Square, this is the worst possible time to talk about a tax on the surplus of any life insurance company.

The tax is contrary to the interest of policyholders. Mutual companies have an obligation to both adequately protect a company's policyholders and to provide insurance at lowest possible cost. The surplus tax produces a conflict between these two obligations.

A separate surplus tax on mutuals would restore the discredited phase system of taxing life insurance companies.

The proposal would create a three-phase tax situation in which

Theoretically some mutuals (and all stock companies) would be taxed on gain from operations after policyholder dividends.

Most mutuals would be taxed based upon imputed surplus earnings.

Some mutuals would be taxed upon gain from operations with no reduction on account of policyholders dividends.

In this respect, the proposal would differ from a true minimum tax. A true minimum would not shift between different types of taxable income, but would simply put a floor under the amount.

It has long been apparent under the 1959 Tax Act that situations of different companies in the same industry, operating under more than one tax basis, create an aggressive tax planning situation in which commerical leasing or selling of assets and liabilities is used extensively to create lower taxes.

We understood that this subcommittee has been seeking a single-phase tax, in large measure to avoid this economic behavior.

A major concern of all parties has been that tax legislation should create a "level playing field" for all parties. By itself, the imposition of a significant tax on surplus would destroy the ability of mutual insurers to compete against stock life companies and other financial intermediaries. It would, in fact, create arbitrary competitive disadvantages between the mutuals themselves.

Policyholder dividends and other kinds of price adjustments are illustrated and paid by both mutuals and stocks. The "differential" theory that treates some part of the price adjustment for a mutual policyholder as a return on equity ignores reality. An excessive differential that enables stock companies to illustrate to prospective policyholders, a lower net cost for individual life insurance than mutuals will make mutuals noncompetitive.

The surplus tax would place mutuals in a rigid tax position, while permitting stock companies the same tax planning options and benefits available to all other taxpayers. The only way to get relief—and only limited relief at that—from this problem would be to choose strategies that might impair growth and compromise solvency.

The surplus tax would not only apply to mutuals but to stock life insurance companies that are subsidiaries of mutuals. Thus a company created and operated as a stock company under law would be tainted by virtue of its mutual company parentage. Today, many stock life insurance companies are wholly owned by large industrial and financial conglomerates. Would Congress consider attributing the tax status of these stock companies to the tax status of their non life insurance parents? If not, we see no justification for singling out stock subsidiaries of mutual insurers and treating them as mutual companies.

A major concern in seeking a level playing field is the impact of a differential tax on the mutuals' ability to sell group insurance; group and individual annuity business; ERISA-qualified business; and other low margins, highly price-sensitive, competitive products such as health insurance, Universal Life and Variable Life insurance.

In these product areas, the purchasers are clearly not interested in "ownership" when making their purchase decisions. Any ownership differential will create an extremely competitive disadvantage to mutuals.

As an example, we offer the following, which illustrates the competitive effect of a differential on the sale of a Universal Life contract. We look at three companies, a stock, a mutual under the current proposal (which produces a 50 percent dividend disallowance to the company, which is actually lower than the disallowance suffered by most of the companies submitting his report) and a mutual under the supposedly "liberal" disallowance of 10 percent of policyholder dividends:

	Stock	Mutual at 50 percent	Mutual at 10 percent
1. Policy amount	$100.00	$100.00	100.00
2. Interest earned (assumed 13 percent)	13.00	13.00	13.00
3. Amount credited to policyholders	12.00	12.00	12.00
4. Guaranteed interest	4.00	4.00	4.00
5. Excess interest credited (=3–4)	8.00	8.00	8.00

	Stock	Mutual at 50 percent	Mutual at 10 percent
6. "Dividend" disallowed	0	4.00	.80
7. Tax on dividend disallowed (at 46 percent)	0	1.92	.37
8. Retained earning—pretax (=2-3)	1.00	1.00	1.00
9. Tax on retained earnings	.46	.46	.46
10. Total tax (=7-9)	.46	2.38	.83
11. Net Profit after tax (=8-10)	.54	−1.38	.17

It is clear from the above that for these modern, low-margin contracts, a "level-playing field" in which all companies can credit their customers equally will result in serious distortions after differential taxation.

Under the proposed legislation, a mutual company cannot sell this business except at an absolute loss. It simply cannot retain enough earnings to pay its imputed taxes.

Even under a more liberal tax treatment, its retained profits *after* equal treatment to policyholders is less than one-third the retained profits of the competing stock company.

Similar problems arise in group life, annuity and other product areas. The peculiar taxation of life insurance companies has resulted in a large loss of business to self-insured, self-funded arrangements. Institutionalization of a differential in these product areas between stock and mutual insurers will merely result in a shift of the remaining insurance industry share to stock companies only.

The surplus tax would adversely affect investment decisions.

The surplus tax would mean that mutual life insurance companies alone would be deprived of any benefit from tax incentives, A.C.R.S. for example, designed to promote economic growth. We are legally required to invest in assets that are expected to produce the highest after-tax yield consistent with safety. Many important investments, such as those in developing urban areas, municipal bonds and exploring for new sources of energy, are favorable today largely because as a result of specific congressional action there are significant tax benefits in making those investments. A surplus tax would mean that the tax benefits associated with those investments would not be available to mutuals. This is cause for great concern to us and, we would hope, to Congress.

There is a clear distinction between insurance consumers who become policyholders of mutual life insurance companies and investors who buy and sell shares in stock life insurance companies. There is a serious question as to why the tax system should require the policyholders of our mutual companies to subsidize those large institutions and wealthy individuals investing in stock companies. In any event, if the Subcommittee still believes that some competitive subsidy or ownership differential against mutuals is proper, the most harmful way to structure it from our standpoint is through a tax on our surplus.

We do not agree that an ownership differential is fair or justified. Nevertheless, an analysis has been made by one of us, Metropolitan, grounded in the arguments and premises of stock companies that a portion of our policyholder dividends should be taxed as the equivalent of stock company dividends to shareholders. This analysis is based on statistics obtained from the A.M. Best Company and shows the amount of shareholder dividends paid by stock companies as a percentage of stock company surplus. This percentage is applied to mutual company surplus and a tax differential is derived which is expressed in terms of a disallowance of a small percentage of policyholder dividends paid by mutuals. This analysis has been made available to you.

Based on this analysis, we would reject the proposed tax on surplus. Instead, we would tax all companies, mutual and stock, on their gain from operations as developed by the Subcommittee, but would permit stocks a deduction of 100 percent of dividends while giving mutuals a deduction of no less than 92½ percent. Further, to assure that there would be no manipulation of dividends that could result in an unwarranted minimizing of tax, we would propose a real minimum tax which would be grounded in mutual companies' gain from operations. This would be a minimum of tax expressed as a percentage of the company's gain from operations prior to any deduction for policyholder dividends. This minimum should apply to all insurance companies.

This approach would provide reasonable revenue grounded in economic income and we believe in an appropriate split of the total tax burden between stocks and mutuals—a split that should appropriately consider their respective shares of assets and life insurance in force.

In summary, we urge your consideration of the approach suggested. We are also willing to consider other alternatives, but must emphasize our strong concern that the surplus tax approach is wrong in concept, would be unfair in implementation, and overall would be extremely harmful to mutual companies.

METROPOLITAN LIFE INSURANCE CO.,
New York, N.Y., August 1, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, House of Representatives, Washington, D.C.

DEAR CHAIRMAN STARK: As part of our submission to your Subcommittee concerning the proposal advanced by yourself and Representative Moore for the taxation of the life insurance industry, we have asked Professor George J. Benston of the Graduate School of Management, University of Rochester, to analyze the proposal, with particular attention directed to the question of the "owership" differential.

Professor Benston's submission will, of course, speak for itself. However, if we may briefly summarize several major items is his report, Professor Benston concludes that the Stark-Moore proposals are an important inprovement over present tax law in most respects. His analysis concludes, however, that there should be no ownership differential. Nevertheless, he points out that, assuming a differential is to be imposed, certain points should be observed.

If part of policyholder dividends are to be construed as an equity return to policyholders, then it becomes necessary to assume that part of the permiums paid by policyholders must be construed as being a capital investment which would be non-taxable to the mutual insurer.

Also, if an ownership differential were to be imposed, it would be more appropriate to base the amount on a study of actual dividends paid to stockholders by stock life companies, than to base any differential on a concept of total equity return.

We believe the submission may be helpful especially, in your consideration of the difficult problem of ownership differential.

We believe the submission may be helpful especially, in your consideration of the difficult problem of ownership differential.

We respectfully request that Professor Benston's submission be filed as part of the record.

Best wishes.

Sincerely

JOHN J. CREEDON,
President and Chief Executive Officer.

THE DEDUCTIBILITY OF POLICYHOLDER DIVIDENDS BY LIFE INSURANCE COMPANIES, BY GEORGE J. BENSTON, PH.D., C.P.A. PROFESSOR OF ACCOUNTING, ECONOMICS AND FINANCE, GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF ROCHESTER

INTRODUCTION

I have been asked by the Metropolitan Life Insurance Company to review the discussion proposal advanced by Chairman Stark and Representative Moore for taxing life insurance companies. As noted above, I am an economist and accountant; my attached curriculum vita provides further information on my qualifications.

The following analysis and conclusions and suggestions drawn therefrom are entirely my own. The Company did not draft or attempt to influence this submission except to ask me to direct, but not limit, my attention to the extent to which policyholder dividends should be considered a deductible expense.

BASIC ASSUMPTIONS

Underlying principles of taxation

As a general rule, life insurance companies should be taxed as are other corporations. The tax should be imposed on their economic income, measured in accordance with generally accepted accounting rules, modified as necessary to make the collection of taxes cost-efficient. In particular, income should be taxed from whatever source derived, except where the tax laws generally mandate exceptions (as with the exclusion from federal taxation of interest on state and municipal obligations). Expenses that are deductible against this income should be those that are incurred to generate that income, as defined generally by the tax code and regulations. Where exceptions are made, for public policy, administrative or other purposes, they should be clearly stated and generally apply equally to similarly situated taxpayers.

THE STARK-MOORE PROPOSALS

The proposals advanced for discussion at the July 28, 1983 hearings (given in Press release #6 of July 14, 1983 and more fully elaborated in Description of Life Insurance Income Tax Proposal July 14, 1983) are significant and welcome improvement of the present tax law. With a few exceptions, these proposals accord well with the principles of taxation given briefly above. Since the background materials and submissions to the Hearings describe the present statute and analyse its shortcomings very well, there is no need for a further discussion.[1] Almost all commentators (including myself) agree that the basic thrust of the proposals is desirable.

However, I must disagree, very strongly, with the proposed treatment of policyholder dividends and the stock subsidiaries of mutuals. Considering the basis principles of taxation that underly the other proposals, the proposed treatment of these items appears based on a misperception of the development and percent economic status of mutual companies and of the economic nature of policyholder dividends. As the following analysis shows, neither reasoning nor evidence supports the assumption that policyholder dividends include a return to equity analagous to stockholders' dividends. In any even, it is logically inconsistent to treat subsidiaries differently depending on the owership of their shares.

THE OWNERSHIP OF MUTUAL LIFE INSURANCE COMPANIES

Mutual life insurance companies were formed originally as voluntary associations of people who pooled their resources and risks for their mutual benefit. As such, the companies existed solely as extensions of the policyholders. At this time, the policyowners were owners of the companies. If this view of mutual life insurance companies were considered to describe them today, they should be taxed (or, more descriptively, not taxed) as are other cooperatives, and distributions to policyholders would be taxed as are distributions to the members of cooperatives.

However, this description of most mutual life insurance companies has not been accurate for a very long time. As a consequence of early contributions of time and other resources by members and supporters of the mutuals, of skillful and conservative management of company resources, and of arbitrary but often favorable tax laws that, from 1921 to 1959, in theory taxed insurance companies only on their free investable income, the mutuals grew and built up equity. This equity (surplus) is not owned by the present policyholders, since they did not contribute or purchase it. The equity is no more theirs than are the net assets of charitable foundations or universities owned by the beneficiaries of the foundations' grants or the universities' students.

Though most mutual life insurance companies (and similar institutions) are not owned by anyone, they are not uncontrolled. The operations of the mutuals are regulated by state agencies and monitored by their boards of directors. Much more important constraints, though, are the self-interested actions of present and potential policyholders and the self-interests of the officers of mutuals. Individuals and businesses seek to obtain insurance policies that serve them best. These policies may be purchased from mutual or stock life insurance companies. The policyholder of either type of company gets only the production purchased. Very few (if any) people are likely to purchase a policy from most mutuals because they want to be members (owners) of an organization (fraternal insurance companies are an exception) or from stocks because they think that insurance companies should be shareholder owned. The officers of mutual insurance companies have incentives to offer competitive products to consumers because the officers benefit as a consequence, as do the officers of stock companies. The stock company officers are monitored in this regard by the demands of shareholders for returns on their investments. For publicly traded companies, if returns are not as great as they would be on alternative investments, share prices will go down and the company will be more likely to be taken over. The incentives of mutual company officers come from the fact that mutuals can obtain capital to replace depreciated capital and to expand their operations only from profits from serving customers. If the officers are not effective in their regard, they face limitations, if no reductions in the salaries and they can obtain from their positions. Thus, the officers of mutuals are rather similar to owner-managers, except that the mutuals are monitored by state insurance agencies.

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[1] See, in particular: "Background on the Taxation of Life Insurance Companies and Their Products," prepared for use of the Committee on Ways and Means by the staff of the Joint Committee on Taxation, May 5, 1983; Henry J. Aaron, "The Peculiar Problem of Taxing Life Insurance Companies," The Brookings Institution, Washington, D.C., 1983; and statement by John E. Chapoton, Assistant to Secretary of the Treasury (Tax Policy) before the subcommittee.

IMPLICATIONS FOR POLICYHOLDER DIVIDENDS

Two important conclusions can be drawn from this analysis. One is that the policyholders have no reason to consider the terms of their life insurance contracts as anything other than the prices paid for the product, whether it is purchased from a mutual or a stock company. Therefore, in buying insurance from a mutual, they have no reason to consider themselves to be shareholders. The second conclusion is that the officers of mutuals (and the officers of stocks) have no reason to consider policyholders as anything other than customers, to whom it is optimal to charge competitive but—importantly—no less than competitive prices. As is discussed next, policyholder dividends are simply one aspect of the price charged to policyholders, and should be treated no differently for tax purposes from other expenses or offsets to revenue.

However, one could argue that the policyholders of mutuals believe that they are getting equity shares in the companies when they purchase a policy. In this event, some part of their premiums would be equity investments. But then, it seems clear that, for the same price as would have to be paid for a policy from a stock company, policyholders of mutuals cannot be obtaining for free a claim on the surplus of a mutual that pre-existed their "membership." If this were the case, it is difficult to understand why anyone would purchase insurance from stock companies. Therefore, if some part of the dividends paid to mutual policyholders are considered to be returns to them as equity holders, some portion of their premiums should be considered to be equity investments. As such, that portion of the premiums should be excluded from the taxable income of mutuals. It is logically inconsistent to include all premiums as taxable income and exclude a portion of policyholder dividends as returns to equity. It is also inconsistent under this theory not to tax policyholders on those returns in a manner equivalent to the dividends received from other corporations. Alternatively, mutuals could be considered to be cooperatives and that part of the policyholder dividends that are not considered to be an adjustment to the price of the insurance policy could be treated as distributions to the members. But, as discussed above, it is logical to view most mutuals as profit-oriented corporations that treat policyholders as customers, not as owners or members. The evidence presented next is consistent with this view.

EVIDENCE THAT MUTUAL COMPANY POLICYHOLDER DIVIDENDS DO NOT INCLUDE RETURN TO OWNERS' EQUITY

If the reasoning presented above were correct, the prices paid by the mutuals' policyholders for insurance, net of policyholder dividends, should be no different than the prices paid by the policyholders of stock companies for similar policies. The required comparison is difficult to make for several reasons. First, the timing of the greater premiums charged for participating policies and the greater dividend returns of premiums must be taken into account by calculating the present values of the expected cash flows. Second, the terms of the policies, such as riders that waive premiums in the event of disability, that permit renewals of term insurance without reexaminations, that charge for installment payments, and that have different settlement options, differ and affect the price. Third, the reputations of companies for service and financial stability affect the desirability of their policies. Fourth, the service and reputation of the agent is paid for in the price of the policy. Perhaps most important, a participating policy represents a risky venture to the policyholder, since the gross premiums are required while the dividends (rebates) are dependent on the company's experience.

Consumer Reports made what is probably the best survey of the cost of insurance. For this purpose, they obtained quotations for standard term and cash-value policies from a large number of mutual and stock companies. They calculated cost indices over a 20 year period that took account of the present dividends.[2] The dividends

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[2] They state that "[i]ndustry critics have charged that, through certain actuarial manipulations, some companies were fudging their figures to make themselves look good at the tradition-

Continued

they used were at the currently paid rates, even though these rates are not at all guaranteed. The same interest rate was used to discount the uncertain dividends as the certain premiums. Consequently, the Consumer Reports study overstates the present value of the dividends, which understates the cost of the participating policies.

Unfortunately, mutual companies offer only participating policies while stock companies offer mostly nonparticipating policies. This makes it impossible to separate the effect of type of policy from type of company. As just noted, all other things equal, one would expect a participating policy to sell at a lower price than a nonparticipating policy because the participating policy exposes a policyholder to considerably more risk. When the insurance contract covers a long period (for an insured person of age 35, some 40 to 50 years), the policyholder is faced with the possibility of greatly varying net premiums compared to the fixed premiums required for a nonparticipating policy. The insurance company is faced with the same risks, though, in the opposite direction. Thus one would expect that a participating policy would sell at a lower price than a nonparticipating policy, much as a variable-rate mortgate requires a lower interest rate than a fixed-rate mortgage.

It would appear, then, that one cannot infer from lower priced participating policies that mutuals include a return to equity amount in the policyholder dividends. However, this hypothesis can be tested by recognizing that the risk discount inherent in participating policies is likely to be large for whole life policies, where the policy term is long and the risk of unexpected changes in investment yields is great. On the other hand, the risk discount for participating term insurance is likely to be slight because unexpected insurance risks over the one to five year term periods are small and very little of the premiums are invested, which minimize investment risks.

The hypothesis that mutuals include a return to equity in policyholder dividends can be tested, then, comparing the rates they charge for similar term policies with the rates charged by stock companies. A similar comparison is made for whole life policies. The data are the cost indices published in Consumer Reports February and March, 1980 issues for $100,000 term policies and $25,000 whole life policies (the most common amounts sold) for persons 25, 35, and 45 years of age. These "prices" are presented in Tables 1 through 6 in ascending order for mutual and stock companies.[3] It is clear from the term insurance policy comparisons (Tables 1, 2 and 3) that the mutuals' policies are somewhat higher priced, on the average. Importantly, though, the data show no patterns. However, Tables 4, 5 and 6 show that the mutuals' participating whole life policies are "priced" significantly lower than are the stocks' nonparticipating policies, as expected. A further confirmation of the expectation that the difference in price reflects a difference in risk and not in type of company is provided by the fact that the Manufacturers Life Insurance Company (a stock) has a cost index of $64 for a participating and $110 for a nonparticipating $25,000 policy for a 25 year old insured. (This is the only reported instance of a company offering both types of policies.) These data, then, are inconsistent with the belief that policyholder dividends are anything other than an adjustment of the premium charged. The tests do not indicate that the dividends include an additional return to equity.

CRITIQUE OF THE STARK-MOORE PROPOSAL FOR ESTIMATING THE AMOUNT OF EQUITY RETURNS IN POLICYHOLDER DIVIDENDS

Even if one assumes that a portion of the dividends received by holders of mutual life insurance company policies are analogous to dividends received by stockholders, the method proposed for estimating these amounts is inappropriate with respect to: (1) the method of calculating the rate of return on equity and (2) the application of the rate to equity as a means of estimating stockholder dividends.

The proposed method of calculating the rate of return on equity

The proposed rate of return "would be set and adjusted to reflect the rate of return enjoyed by commercial enterprises generally"—an average of "the rate of return earned by stock life insurance companies. . . , the rate of return earned by the top 400 industrial corporations, and the rate on one-year Treasury bills (gossed

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al 10-20 comparison points. We wanted to protect our results against such manipulation, if it existed. As it turned out, however, our method uncovered little evidence of manipulation among companies responding to our questionnaire" (Consumer Reports, February 1980, p. 89).

[3] Companies that offer insurance only to a limited group or that offer insurance directly only, without agents, are excluded since their policies are not comparable to those of the general companies.

up by the corporate tax rate)."[4] There is no reason to believe that this rate would meaningfully measure the economic profits of mutual life insurance companies.

Taking the three elements in reverse order, the Treasury bill rate is a short-term riskless rate of return. It does not reflect either the nonrepayment or the inflation risks inherent in most corporate investments. Consequently, it is likely to understate the rate applicable to investments in life insurance operations, But there is no reason to believe that increasing it by dividing by one less the corporate tax rate corrects this difference—if anything, it would seem to result in an overstated rate.[5]

The rate of return reported by large industrial corporations reflects the risk of their operations, which are likely to be quite different than the risk of life insurance company operations. Furthermore, the reported rates of return are calculated from historical accounting numbers which do not reflect well economic values. In times of inflation particularly, long-term assets and liabilities tend to be seriously understated. Since the long-term assets of industrial companies usually greatly exceed their long-term liabilities, their equities tend to be understated. At the same time (and for the same reason) depreciation expense is understated, which results in an overstatement of net profit. Hence, with overstated income and understated equity, their return on equity is overstated. In contrast, life insurance companies attempt to match their long-term liabilities with long-term assets. For these and other reasons, the reported returns to industrial corporations' equities are not relevant to the issue at hand.

Finally, the rate of return for stock life insurance companies reflects the risk of their operations and the package of products they sell. These risks and products are rarely directly comparable to those offered by mutual life insurance companies. Furthermore, the rates reported by stock companies have a considerable range. These pretax profit rates for 1982, 1981 and 1980 and the average of the three years, calculated on a GAAP (generally accepted accounting principles) basis before tax, on common equity for the 22 unique parents of the 25 largest stockholder-owned companies are given in Table 7.[6] The rates of return are ordered by the three average and the medians and quartiles for each are indicated. As the table shows, these rates of return vary widely among companies and, for the same company, between years. Even the three average range from 37.8 percent to −3.7 percent. The annual average, which dampen considerably the variations in individual returns, range from 14.3 percent to 21.6 percent. An annual or three year average of these rates is no more "correct" than in any of the 6 (22 X 3) annual numbers given in the table.

The application of the rate to equity as a means of stockholder dividends

Most importantly, the object of the change in the tax status is said to be the equitable taxation of life insurance companies. The accounting rate or return of any company yields a very poor measure of its economic income. The application of the average accounting rates of return of one set of companies, even reasonably similar companies, to another set of companies is likely to result in a very poor measure of economic income. Hence, this method of correcting a supposed and unlikely overdeduction of expense would clearly seem to introduce a very substantial bias into the tax liability calculations for mutuals.

If it is believed that some part of policyholder dividends is a return to their supposed equity investments, and if for some reason it is not clear that these investments would have had to have been made in the form of premiums that should, therefore, be excluded from taxable income, then the amount could be estimated more directly. Assuming that mutual and stock life insurance companies are directly comparable, the dividend rate paid by the stocks could be taken to be the rate that mutuals pay to their "shareholders." At least this calculation addresses the issue directly. The issue, after all, is the amount of returns of equity that mutuals may have distributed to policyholders, not the amount of the mutual's economic net income.

Table 8 gives the dividend payout rate on common equity for each of the 22 unique parents of the 25 largest stock companies for 1982, 1981 and 1980, and the average of the three years. These rates vary less than the market rate of return given in Table 7 because dividends paid are more stable than net profit and, unlike net profit, are measured without error. Nevertheless, the dividend rates show considerable variations among companies and, for the same company, between years. The three year average ranges from 0.0 percent to 8.8 percent while the annual rates range from 0.0 percent to 10.2 percent. To apply an average of these rates to *all* mutual companies as a means of estimating the stockholder dividends included in policyholder dividends would seem to be inequitable. But it is far preferable to the procedure offered in the present proposal.

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[4] "Description of Life Insurance Income Proposal," July 14, 1983, p. 9.

[5] It may be that the suggested "grossing up" was derived from Henry Aaron's "Method 3," in which the long-term municipal bond rate was grossed-up and then used as the rate of return on equity (p. 35). Aaron grossed-up this rate because municipal bond interest is tax free; the grossed-up rate then approximated the taxable interest rate. It makes no sense to gross-up the taxable rate once more.

[6] These rates are overstated somewhat since preferred dividends were not always subtracted while equity excludes preferred capital.

THE EFFECT OF NOT PERMITTING MUTUALS TO DEDUCT ALL OF THEIR POLICYHOLDER DIVIDENDS AS EXPENSES

If the conclusions of this analysis are not accepted, mutuals will have to pay higher taxes than similarly situated stock companies. A consequence of this higher tax is *not* that the mutuals will not be able to compete with stocks in the short run. Mutuals still must offer consumers a competitive price (including the value of service and security). Those mutuals that raise this price to compensate for the higher tax will lose customers to the insurance companies that don't. However, the tax on policyholder dividends (for that is what is proposed) will raise the mutuals' cost of providing participating life insurance to people if the amount of the tax were dependent on the amount of the policyholder dividends paid out. Should stock companies be permitted to offer participations in the form of rebates of excess interest earnings (which is conceptually and economically the same as the mutuals' participating dividends), the stocks' marginal costs would be lower than those faced by mutuals. Hence the stocks' optimal prices would be lower than the mutuals' optimal prices—the stocks would have a competitive advantage. As a consequence, mutuals would have to shift away from participating insurance and/or restructure their products to reduce the tax, perhaps by increasing initial premiums and reducing the rebates. A further consequence, then, would be that consumers would not be offered the types of insurance they might want.

The converse situation also should be considered. Assume that it were true that a portion of the mutuals' policyholder dividends is a return to the equity investments of policyholders and that these amounts nevertheless were allowed as deductions against taxable profits. In this event, the mutuals would not have a competitive pricing advantage over the stocks since the mutuals' marginal costs or benefits from insurance operations and sales would not be affected.[7] Hence, the optimal price at which they want to sell insurance would not be affected. (As was discussed above, they have no incentive to give the presumably lower tax to their customers.) Rather, the effect of the mutuals having equity that is free of stockholder demands is that they are able to retain more earnings.

The principal effect or differential taxation, then, is on the financial stability and growth of mutuals. They can replace and augment their capital only from retained profits. The effect of the 1959 law was to tax mutuals at higher rates than many stocks were taxed. As a consequence, investors got higher returns, equity funds were attracted to stock life insurance companies, and they expanded. In 1959 the stocks had 25 percent of total industry assests and 37 percent of insurance in force. By 1982, these percentages increased to over 45 percent of the assets and over 50 percent of the insurance. If the proposed disallowance of the mutuals' expenses (policyholder dividends) is written into the law, the mutuals' position will erode further. In addition, they may be forced to restrict the product they offer to consumers. It is not clear why these results are desirable public policy.

STOCK LIFE INSURANCE COMPANIES OWNED BY MUTUALS

The Stark-Moore proposal would tax the policyholder dividends of stock subsidiaries of mutuals as if these companies were mutuals. This procedure would be completely inconsistent with the reasoning underlying the proposal's reduction of the mutuals' deductions against taxable income of policyholder dividends. The reduction would be imposed because the mutuals' policyholders are seen as owners of the mutuals, with a portion of the dividends received being returns to their presumed equity in the mutuals. But the policyholders of any stock company cannot have equity interests in the company. It matters not whether the stockholders are individuals, pension funds, or other stockholder owned or mutual companies.

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[7] An exception could be the extent to which the mutuals' policyholders benefit from the dividends not being taxed to them. But this exception is not relevant, since the amounts are likely to be within the dividend exclusion limits for most individuals, and since the proposed legislation does not suggest subjecting the presumed equity returns to personal income tax.

The fact that this tax treatment of stock companies owned by mutuals but not by others is proposed leads me to wonder whether the proposed legislation really is based on an assumed return to ownership by policyholders of mutuals. Rather, it appears consistent with an intent to disadvantage mutual life insurance companies as compared with stocks. The reason for this intent might be the fear that mutuals could and would otherwise underprice the products sold by stocks because the mutuals do not have to pay shareholders a return on their investments. If so, I suggest that this fear is not logically grounded. As discussed above, the officers of mutuals have no incentive to offer their products at other than competitive prices—they have no reason to give potential policyholders gifts. Rather, the effect of the differential taxation proposed is to disadvantage mutuals with respect to their capital maintenance and growth as is discussed above.

SUMMARY

The analysis presented above yields the following conclusions:

1. The Stark-Moore proposals are an important improvement over the present tax law in most respects. The principal exceptions relate to the proposals to reduce the deduction of the policyholder dividends paid by mutuals and their stock subsidiaries.
2. Mutual life insurance companies cannot be said to be owned by their customers—the policyholders. Alternatively, if the customers were believed to own the companies, the companies should be taxed as cooperatives.
3. If one believes that policyholders are stockholders, their capital investments in the mutuals must have been and will be made with their premiums. But, under a gain from operations tax, premiums are considered to be taxable income. If, under the present proposals, policyholders (particularly new ones) were considered to be stockholders, a portion of their premiums should be labeled as non-taxable capital investments rather than as income. It would be equivalent, though, to consider all premiums as income and all policyholder dividends as expense.
4. Policyholder dividends, though, are simply a means of pricing policies such that the policyholder accepts the cost of uncertainty. As such, policyholder dividends represent an element of the cost of the policies to policyholders and to the mutuals. The data analyzed on the costs of policies issued by mutuals and stocks are consistent with this view of policyholder dividends.
5. In any event, the method suggested in the proposal for estimating the supposed amount of equity returns in policyholder dividends is seriously flawed. The average rate of return calculation yields numbers that bear scant relationship to economic income.
6. If some such method were mandated, there would be at least some reason supporting estimating the mutuals' equity dividends as equal to the dividend rates on equity paid by stock life insurance companies.
7. If mutuals were not permitted to deduct all of the policyholder dividends as expenses, the result would be restrictions on their growth and possible impairment of their capital, but not necessarily higher prices for their products, though they might find it desirable to alter these products to reduce their tax burden. Conversely, if they were taxed equitably, their capital and hence their growth and stability would be enhanced, but they do not thereby obtain a competitive pricing advantage over the stockholder-owned companies.

Table 1

20-Year Cost Indices
$100,000 Term Insurance
Age at Issue 25 Years

Mutual Companies		Stockholder Owned Companies
		223 U.S.A.A. Life Ins. Co.
Security Benefit Life	238	
		244 All American Life & Casualty
		244 U.S. Life in the C. of N.Y.
		245 United Benefit LIC
		247 All American L&C Co.
		247 U.S. LIC in the City of N.Y.
		249 NA Co. for L&H Ins.
		249 Old Line LIC of America
		249 N.A. Co. for L&H Ins.
		251 Fireman's Fund Am. LIC
		253 Occidental LIC of Ca.
		254 Anchor National LIC
		254 NW National LIC
		255 Sun LIC of America
		256 Federal Kemper
		256 Beneficial LIC
Equitable	257	
		257 United Investors
		258 Equitable LIC of Iowa
		259 Monarch LIC
Metropolitan	261	
		262 First Colony
		262 Columbus Mutual
		265 Midland National
		267 Federal Kemper
		268 Security-Conn. LIC
		270 Aetna LIC
Pacific Mutual	271	
		272 Provident L&A IC
		272 Provident L&A IC
		272 Security Ct LIC
		273 Continental A.
		273 National L&A of Can.
		273 State Farm LIC
Metropolitan	275	
Midland Mutual	275	
Mutual of N.Y.	276	
		276 Hartford LIC
		277 Time Ins. Co.
Penn Mutual	278	
		279 Jefferson Std.
		280 Southland L&C
		281 Safeco LIC
Minnesota Mutual	281	
		281 Kansas City L&C
		281 IDS LIC
		282 Great West L&C
Central Life	284	
		285 Southern Farm Bureau

Table 1 Continued

		286	J.C. Penney LIC
Prudential	286		
		287	Commonwealth LIC
New England Mutual	288		
New York Life2	289		
		296	USAA LIC
Indianapolis	299		
Mutual Benefit	305		
Union Central	307		
Ohio National	307		
Provident Mutual	311		
		312	Bankers LIC
Mean:	282.7	265.5	
t statistic of difference:	3.508		

Table 2

20-Year Cost Indices
$100,000 Term Insurance
Age at Issue 35 Years

Mutual Companies		Stockholder Owned Companies	
		408	USAA LIC
		437	All American L&C
		437	US LIC in the C. of N.Y.
		444	United Benefit LIC
		449	All American L&C Co.
		449	US Life in the C. of N.Y.
		455	Fireman's Fund Am LIC
		457	Security Conn. LIC
		463	Equitable LIC of Iowa
		463	Great West L&C
Security Benefit	463		
		466	N.W. National LIC
		467	Great West L&C
		468	NA Co. for L&H Ins.
		468	NA Co. for L&H Ins.
		469	Old Line LIC of America
		470	Columbus Mutual
		473	Security Conn. LIC
		478	United Investors
		480	First Colony
		481	Sun LIC of America
		481	Monarch LIC
		483	Federal Kemper
		484	Occidental LIC of Ca.
		484	Aetna LIC
		485	Beneficial LIC
		485	Anchor National LIC
Equitable	487		
		487	Federal Kemper
		490	American States
Midland Mutual	491		
Pacific Mutual	497		
Manufacturers	501		
		511	IDS LIC
		511	American States
		512	Midland National
		513	Kansas City LIC
		513	Southern Farm Bureau
		514	Southland LIC
		514	Continental A.
		515	Provident L&A
		515	J.C. Penney LIC
		517	Provident L&A IC
		518	Jefferson Std
		521	Hartford LIC
		521	USAA LIC
Penn Mutual	523		
		523	State Farm LIC

Table 2 Continued

Metropolitan	523		
Mutual of New York	532		
Central Life	532		
Minnesota Mutual	542		
New England Mutual	545		
Indianapolis	545		
New York Life	554		
Ohio National	557		
		558	Bankers Life Co.
New York Life	561		
Mutual Benefit	575		
Union Central	581		
Mean:	529.9	484.6	

_t_ statistic of difference: 5.12

Table 3

20-Year Cost Indices
$100,000 Term Insurance
Age at Issue 45 Years

Mutual Companies			Stockholder Owned Companies
		970	USAA LIC
Prudential	1052		
		1053	Great West LAC
		1054	Great West LAC
		1056	Security Conn. LIC
		1069	US LIC in the C. of N.Y.
		1069	All Amer. L&C Co.
		1077	NW National LIC
		1078	United Benefit LIC
		1085	USAA LC
		1103	All American L&C Co.
		1103	US LIC in the C. of N.Y.
		1104	Security Conn. LIC
		1109	American States
		1112	Fireman's Fund Am L&C
		1113	Aetna L&C
Security Benefit	1118		
		1136	Old Line LIC of Am.
		1138	First Colony
		1138	American States
		1140	Anchor National L&C
Manufacturers	1145		
		1149	Sun LIC of America
		1151	Southern Farm Bureau
		1152	Occidental LIC of Ca.
		1163	United Investors
		1166	Southland LIC
Pacific Mutual	1166		
		1176	J.C. Penney LIC
		1187	IDS LIC
		1192	Kansas City LIC
		1193	Beneficial LIC
		1195	Columbus Mutual
		1197	Federal Kemper
		1203	Old Line
		1206	Continental A.
Equitable	1208		
		1208	Monumental
		1209	Equitable LIC of Iowa
		1212	N.A. Co. for L&H Ins.
		1213	Jefferson Std.
		1214	Provident L&A IC
		1214	N.A. Co. for L&H Ins.
		1221	Federal Kemper
New York Life	1221		
		1226	Midland National
Penn Mutual	1246		
		1251	State Farm LIC
Acadia Mutual	1270		

Table 3 Continued

Minnesota Mutual	1274		
		1277	Monarch LIC
Mutual of N.Y.	1279		
Central Life	1291		
New York Life	1309		
New England Mutual	1315		
Indianapolis	1346		
Union Central	1350		
Ohio National	1355		
		1355	Bankers Life Co.
Provident Mutual	1365		
Mutual Benefit	1368		
Mean:	1259.9	1154.4	

_t_ statistic of difference: 4.806

Table 4

20-Year Adjusted Cost Indices
$25,000 Whole Life Policy; Age at Issue = 25

Mutual Companies			Stockholder Owned Companies
Phoenix Mutual	39		
Home	43		
Central	50		
Mass. Mutual	55		
		56	Continental Assurance
New England Mutual	57		
Union Mutual	58		
Mutual of New York	59		
Northwestern Mutual	60		
Guardian	61		
Manufacturers Life	64		
Standard Insurance Co.	66		
		68	USAA Life Ins. Co.
Columbia Mutual	71		
Minnesota Mutual	72		
		73	Bankers Life
Connecticut Mutual	74		
		82	Provident Life & Accident
		85	Equitable Life Ins. Co. of Iowa
		87	Old Line Life Ins. Co. of America
		95	Time Insurance Co.
		97	Home Benefit Life Ins. Co.
		98	Life & Casualty Ins. Co. of Tenn.
		98	Occidental Life Ins. Co.
		100	Allstate Life Insurance Co.
		100	All American Life & Casualty
		100	American States Life & Casualty
		100	US Life Ins. Co. in the C. of NY
		101	Kansas City Life Ins.Co.
		104	Federal Kemper
		105	Fidelity Union
		105	Travelers
		105	Southwestern Life Co.
		109	Monarch
		110	Colonial Life Ins. Co.
		111	Lincoln National
		114	J.C. Penney
		115	Dominion Life Assurance Co.
		115	IDS Life Ins. Co.
		115	Paul Revere Life Ins. Co.
		119	American National Ins. Co.
		120	Midland National Life Ins. Co.
		120	United Investments
Mean:	59.2	100.2	
t statistic of difference :		-8.89	

Table 5

20-Year Adjusted Cost Indices
$25,000 Whole Life Policy, Age at Issue 35

Mutual Companies			Stockholder Owned Companies
Home	80		
Central	82		
Phoenix Mutual	85		
Continental	89		
Northwestern Mutual	93		
Mass. Mutual	95		
Union Mutual	97		
		101	USAA Life Insurance Co.
Manufacturers	101/173		
Guardian	102		
New York Life	104		
New England Mutual	105		
Standard Insurance Co.	105		
Colombia Mutual	106		
Equitable	110		
		112	Bankers Life
Connecticut Mutual	112		
		141	Continental Assurance
		141	Old Line Life Ins. of America
		147	Provident Life & Accident
		151	Equitable Life Ins. Co. of Iowa
		152	Life & Cas. Ins. Co. of Tenn.
		154	Kansas City Life Ins. Co.
		159	Security - Co.
		160	American States Life Ins. Co.
		161	Home Benefit Life Ins. Co.
		162	All American Life & Cas. Co.
		162	US Life Ins. Co. in the C. of NY
		164	Time Ins.Co.
		165	J.C. Penney
		167	Occidental Life Ins. Co.
		170	Lincoln National
		171	Fidelity Union
		172	Southwestern Life
		173	Dominion
		173	Federal Kemper
		173	Travelers
		174	Monumental
		175	Aetna
		175	IDS Life Ins. Co.
		175	Allstate Life Ins. Co.
		177	Franklin
		179	Commonwealth
		179	Midland
		181	INA
		182	Colonial Life Ins. Co.
		183	Durham Life Ins. Co.
Mean:	97.7	162.8	

t statistic of difference: -12.569

1/1

Table 6

20-Year Adjusted Cost Indices
$25,000 Whole Life Policy, Age at Issue 45

Mutual Companies			Stockholder Owned Companies
Home	177		
Central	178		
Northwestern Mutual	189		
Phoenix Mutual	190		
		194	USAA Life Insurance Co.
Massachusetts Mutual	194		
Union Mutual	200		
Standard Insurance Co.	211		
Manufacturers	211/312		
Columbia Mutual	213		
Lutheran Mutual	214		
New England Mutual	218		
		223	Bankers Life
Connecticut Mutual	224		
		275	American States Life Ins. Co.
		284	Life & Cas. Ins. Co. of Tenn.
		284	Old Line Life & Ins. Co. of Am.
		287	Kansas City Life Ins. Co.
		289	Security - Ct.
		295	Continental A.
		298	Home Benefit Life Ins. Co.
		302	All American Life & Cas. Co.
		302	J.C. Penney
		302	Lincoln National
		302	US LIfe Ins. Co. in the C. of NY
		304	Connecticut General
		304	Dominion Life Assur. Co.
		309	Equitable Life Ins.Co. of Iowa
		310	Time Insurance Co.
		312	Provident Life & Accident
		319	INA
		320	Fidelity Union
		320	Southwestern L.C.
		322	Monumental
		325	Commonwealth
		325	Northwestern National L.I. Co.
		326	Federal Kemper
		327	Aetna
		327	Travelers
		328	SAFECO
		329	Franklin L.I. Co.
		333	Midland National L.I. Co.
Mean:	201.6	302.6	
t statistic of difference:		-10.973	

Table 7

Pretax Profit Rate = Pretax Profit ÷ Common Stockholders' Equity

22 Unique Parents of 25 Largest Stockholder Owned Life Insurers

Parent Co./Main Life Subsidiary	3-Year Average	1982	1981	1980
First Executive Corp./ Executive Life	37.8%	19.5% Q3	54.2%	39.7%
American Brands/Franklin Life	34.5	34.7	33.1	35.7
Provident Life & Accident	27.6	23.7	32.0	27.1
Charter Corp./Charter Sec. Life	25.1	20.5	28.9	25.9
Tenneco/Southwestern Life	23.4	20.4	24.2	25.6
State Farm Mutual Ins. Co./ State Farm Life	22.4 Q3	20.7	23.5	23.0
Continental Assurance Co./Loews	22.3	18.7	23.8 Q3	24.5 Q3
Allegheny Corp./IDS Life	21.3	19.3	25.7	19.0 Q2L
Northwestern National Life Ins. Co.	18.3	14.9	18.4 Q2U	21.6
American General/National Life & Accident	18.2	13.3 Q2L	18.9	24.1
Transamerica/Transamerica Occidental	16.9 Q2U	11.4	18.9	20.5
Torchmark/Liberty National Life	16.6 Q2L	15.8	17.2 Q2L	16.9
CIGNA/Connecticut General Life	16.3	11.0 Q1	19.3	18.4
American National Corp./American National Life	15.6	11.7	15.9	19.1 Q2U
Kemper Corp./Kemper Investors Life	14.9	13.1	14.3	17.5
Travelers Corp./Travelers Insurance	14.1	10.7	14.2 Q1	17.4 Q1
Washington National Corp./ Washington National Life	13.9 Q1	8.5	14.4	18.8
Nationwide Corp./Nationwide Life	13.6	12.1	13.2	15.6
United Of Omaha Life/Mutual of Omaha	11.5	14.5 Q2U	5.4	14.8
Lincoln National Corp./Lincoln National Life	11.4	9.2	10.0	15.0
Aetna Life & Casualty/Aetna Life Ins. Co.	10.7	4.9	10.5	16.8
Baldwin-United/National Investors Pension	-3.7	-13.4	-16.5	18.8
Mean:	18.3	14.3	19.0	21.6

Q3 = Top ¼ of companies at or above this level.
Q2U = Top ½ of companies at or above this level.
Q2L = Bottom ½ of companies at or below this level.
Q1 = Bottom ¼ of companies at or below this level.

1/1

Table 8

Dividend Payout Rate = Common Dividends Paid ÷ Common Stockholders' Equity
22 Unique Parents of 25 Largest Stockholder Owned Life Insurers

Parent Co./Main Life Subsidiary	3-Year Average	1982	1981	1980
American Brands/Franklin Life	8.8%	10.2%	9.6%	6.7%
Provident Life & Accident	7.7	7.4	7.8	7.8
Tenneco/Southwestern Life	7.7	7.4	7.7	7.9
Transamerica/Transamerica-Occidental	5.4	5.5	5.4	5.3
Aetna Life & Casualty/Aetna Life Ins.Co.	5.1	5.0	5.2 Q3	5.2
CIGNA/Connecticut General Life	5.0 Q3	4.0 Q2L	7.4	3.7 Q2U
Lincoln National Corp./Lincoln National	4.7	4.6	4.9	4.7 Q3
Baldwin-United/National Investors Pension	4.6	4.3	4.9	4.6
Travelers Corp./Travelers Ins.	4.3	4.7	4.3 Q2U	4.0
Torchmark/Liberty National LIfe	4.3	4.4	4.5	4.1
American General/National Life & Accident	4.3 Q2U	3.9	4.8	4.3
Charter Corp./Charter Sec. Life	3.9 Q2L	4.1 Q2U	4.0 Q2L	3.6
Washington National Corp./Washington National Life	3.7	3.6	3.9	3.7 Q2L
American National Corp./American National Life	3.7	5.0 Q3	3.1	2.9
Kemper Corp./Kemper Investors Life	3.5	3.9	3.5	3.2
Northwestern National Life Ins. Co.	2.8	2.9	2.7	2.8
Nationwide Corp./Nationwide Life	1.8 Q1	1.6 Q1	1.8 Q1	1.9 Q1
United of Omaha Life/Mutual of Omaha	1.2	1.1	1.2	1.2
Continental Assurance/Loews	1.1	1.0	1.1	1.3
Allegheny Corp./IDS Life	0.3	0.3	0.4	0.4
State Farm Mut. Ins. Co./State Farm Life	0.1	0.1	0.1	0.1
First Executive Corp./Executive Life	0.0	0.0	0.0	0.0
Mean:	3.8	3.8	4.1	3.6

Q3 = Top ¼ of companies at or above this level.
Q2U = Top ½ ofcompanies at or above this level.
Q2L = Bottom ½ of companies at or below this level.
Q1 = Bottom ¼ of companies at or below this level.

GEORGE J. BENSTON

December, 1982

Personal

Age 50 (born March 18, 1932, New York City)
Married, wife (Alice) is Ph.D., Associate Professor of Comparative Literature, College of Arts and Science, University of Rochester
Children, two boys (both married), ages 29 and 27
Veteran, U.S. Navy (LTJG), 1953-1956.

Education

Degrees Earned:

Ph.D. (Economics), 1963, University of Chicago, Graduate School of Business
M.B.A. (Accounting and Taxation), 1953, New York University, Graduate School of Business Administration
B.A. (Liberal Arts and Accounting), 1952, Queens College (cum laude)
C.P.A. North Carolina, 1955

Honors and Awards:

American Accounting Association Distinguished International Lecturer for 1980 (Lectured in Central and South America)
Beta Gamma Sigma Distinguished Scholar for 1975
Phi Beta Kappa (Queens College)
Beta Gamma Sigma (New York University)
C.P.A. examination passed with highest marks in the state
Departmental Honors - Economics (Accounting), Queens College
Ford Foundation Dissertation Fellow, 1961-62
Federal Reserve Bank of Chicago Research Fellow, 1960-61
United States Steel Foundation Fellow, 1958-59 and 1959-60
Woodrow Wilson Fellow (Honorary), 1958-59
Tuition Scholarships, New York University

Nominated for Vice-President (President-Elect), American Finance Association for 1980 (Franco Modigliani was elected)

American Accounting Association Competitive Manuscript Award, First prize 1966 for "Multiple Regression Behavior of Cost Behavior"

Positions

Teaching:

1969-Present	Professor of Accounting, Economics and Finance Graduate School of Management University of Rochester

Teaching (continued)

1979-Present	Invited Lecturer, Law and Economics Center, Emory University Advanced Courses for Federal Judges in Statistics, Econometrics and Financial Data Antitrust Economics Economics Institute for Law Professors
1981 (Lenten Term)	Visiting Professor of Accounting London School of Economics
1979 (Summer)	Arthur Young McClelland Moores Distinguished Visiting Professor London Graduate School of Business Studies
1978 and 1972	Distinguished Visiting Faculty American Accounting Association Doctoral Consortium
1973 (Spring)	Visiting Professor London Graduate School of Business Studies London School of Economics Hebrew University of Jerusalem (May)
1966-1969	Associate Professor of Accounting and Finance College of Business Administration University of Rochester
1962-1966	Assistant Professor of Accounting Graduate School of Business University of Chicago
1963 (Summer)	Visiting Assistant Professor of Finance University of California Berkeley
1956-1958	Instructor and Assistant Professor of Accounting Georgia State College, Atlanta

Consulting:

Various Times	Expert witness on regulation, SEC, and antitrust cases
1981-1982	Academic Advisory Committee, Study of the Payments Mechanism conducted by Arthur D. Little, Inc. funded by The Association of Reserve City Bankers
1981-1982	Visiting Scholar, Federal Reserve Bank of Atlanta
1969-1978	Federal Reserve Board, Washington, D.C.
1970-1972	National Commission on Consumer Finance
1970-1971	Commission on Financial Structure and Regulation (Hunt Commission)
1970-1971	Savings Banks Association of New York State
1970-1971	Morgan Guaranty Trust Company of New York (paper on overdraft banking)

Consulting (continued)

1966-1969	Federal Home Loan Bank Board, Washington, D.C.
1965-1968	American Bankers Association, Banking and Financial Affairs Sub-Committee
1965-1966	Regional Economic Advisor, Comptroller of the Currency
1964-1965	Banking and Currency Committee, House of Representatives
1964-1966	NABAC, The Association for Bank Audit, Control and Operations (now Bank Administration Institute)
1957-1958	The First National Bank of Atlanta

Testimony:

Various Times	U.S. Senate and House Judiciary and Banking Committees

Industry:

1956-1957	The First National Bank of Atlanta Accounting and Tax Specialist
1953-1956	Auditor and Supply Officer (LTJG) U.S. Navy: Cost Inspection Service, Mobile Audit Staff, Atlanta, GA and Resident Auditor, Western Electric Company, Burlington, NC
1952-1953	Accountant, Benjamin Smith & Company, CPA, N.Y.C.
1952-1953	Junior Accountant, David Shain & Company, CPA, N.Y.C.

Publications (grouped, roughly, by subject areas)

Accounting (including accounting-economics and accounting-finance)

Books:

Contemporary Cost Accounting and Control, editor, Dickenson Publishing Company, Belmont, CA, First, 1970, Second, CBI Publishing Company, Boston, MA, 1977

Corporate Financial Disclosure in the U.K. and the U.S.A., Saxon House/ Lexington Books (D.C. Heath) and the Institute of Chartered Accountants in England and Wales (London), 1976

Monograph:

Investors' Use of Published Financial Accounting Data: A Review of the Evidence from Research, University of Glasgow Press (an earlier version was delivered as the Arthur Young Distinguished Lecture presentation, Glasgow University, October 1979)

Accounting (continued)

Articles in Academic Journals and Publications:

"Appraising the Defensive Position of a Firm: The Interval Measure," with George H. Sorter, The Accounting Review, XXXV, October 1960, 633-640

"The Role of the Firm's Accounting System for Motivation," The Accounting Review, XXXVIII, April 1963, 347-354. (Reprinted in Benston, Contemporary Cost Accounting and Control)

"Multiple Regression Analysis of Cost Behavior," The Accounting Review, XLI, October 1966, 657-672. (First Prize American Accounting Association Manuscript Contest, read before 1966 Annual AAA Meeting, Miami, Florida.) (Reprinted in Studies in Cost Analysis, second edition, edited by David Solomons, Irwin, 1968 and in Benston, Contemporary Cost Accounting and Control)

"Published Corporate Accounting Data and Stock Prices," The Journal of Accounting Research, Empirical Research in Accounting: Selected Studies, 1967, 1-54

"The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements," in Economic Policy and the Regulation of Corporate Securities, edited by Henry G. Manne, the American Enterprise Institute, Washington, D.C., 1969, 23-79

"The Value of the SEC's Accounting Disclosure Requirements," The Accounting Review, XLIV, July 1969, 515-532; originally presented to the Annual Meeting of the American Accounting Association, San Diego, California, August 1968

"Required Disclosure and The Stock Markets: An Evaluation of the Securities Exchange Act of 1934," American Economic Review, LXIII, March 1973, 132-155

"Financial Reporting and the Stock Market: "Evaluation of the Securities Exchange Act of 1934," George J. Benston; "The Other Side," A.A. Sommer, Jr.; "Comments on 'The Other Side', George J. Benston," Financial Executive, May 1974, 28-42. (This is a less technical version of "Required Disclosure and the Stock Market: An Evaluation of the Securities Act of 1934," that appeared in the American Economic Review, March 1973

"A Critique of the Rationale for Required Corporation Financial Disclosure," in Emanuel Saxe Distinguished Lecture Series, 1973-74, Reed K. Storey, ed., Baruch College, City University of New York, 1975, 37-52

"Accountants' Integrity and Financial Reporting," Financial Executive, XLIII, August 1975, 10-14

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"An Investigation of the Housing Location Choice," with Dan Horsky, funded by The National Science Foundation

"The Methodology of Redlining Research and The Rochester Experience," with Dan Horsky and H. Martin Weingartner

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Editor - Director, Sixty-fourth American Assembly on The Future of American Services Institutions, April 1983 (Volume of papers to be published by Prentice-Hall)

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"Studies in Banking Costs," a series of papers with Gerald Hanweck and David Humphrey (and several other related papers)

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Major Professional and Community Activities

Trustee (elected), College Retirement Equities Fund (CREF), 1977-1981

Director, The Center for Study of Financial Institutions and Securities Markets, Graduate School of Management, University of Rochester, 1975 to present

Associate Editor, Journal of Money, Credit and Banking, 1980-present

Editorial Board, The Journal of Bank Research, 1970-present

Editorial Board, The Accounting Journal, 1976-present

Editorial Board, Journal of Financial Research, 1981-present

Editorial Board, Journal of Accounting and Public Policy, 1981-present

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Editorial Board, Journal of Finance, 1973-1978

Editorial Board, The Accounting Review, 1971-1973, 1977-1978

Editorial Board, Wall Street Review of Books, 1972-1974

Referee for many other journals

National Science Foundation, Projects Review Committee and referee

Chairman and member, Tenure and Promotions Committee, Graduate School of Management, University of Rochester, 1972-1979, 1980-present

Member, Admissions Committee, Graduate School of Management, University of Rochester, 1967-1970, 1979-1980

Member, University Library Director Search Committee, University of Rochester, 1976-1977

Chairman and member, University of Rochester Senate Committee on Research Policy and External Grants and Contracts, 1969-1972

Chairman and member, University of Rochester Senate Committee on the Improvement of Teaching, 1968-1970

Director, Business Economists Conference, University of Chicago, 1965 and 1966

Chairman, Unity Organization for Hyde Park High School, 1964-1966. (Developed a plan for a comprehensive, integrated Secondary Education Park, organized community groups and almost convinced the Chicago Board of Education to adopt the plan)

Chairman **Stark**. I want to thank the panel, particularly Mr. Garber, who has been most generous with his time and counsel to the subcommittee members and to the staff in helping us make some semblance of order out of what has been a chaotic couple of months.

I know it has been of some personal discomfort to you in attending, and I doubly appreciate your attending.

I just have some observations, and one is that I have heard, through the mutual testimony, talking about gain from operations, I don't know—as anybody—the problem is, you can't compute the gain from operations, unless you are willing to quantify the redundancy, so there is no way to calculate gain from operation unless we can empirically determine what is redundant premium and what is going back in the nature of ownership dividends.

It is not gain from operations that we can peg. We can say that that is what it is, but you guys said it because the dividend policy is at best whimsical. It is your decision.

If you deduct any dividend, you will guarantee, unless your company fails to earn it in the aggregate in that year. You want to try that? No. You say you can't compete, and that is true if you insist on continuing to market a product that has redundancy. Well, I am not suggesting you ought to change your market policies. You could continue by pricing without the redundancy, as you will do in investment-type products, as you compete in that area.

I am sympathetic to the differences in companies, but I am not sure that higher and lower surplus companies, which is the basis for the argument that we are unfairly impacting different groups within your segment of the industry again is not your decision.

That may have been a decision in past years of how much of your income you are going to pay out to your policyholders, which may have been competitive, tactical, but it is really not a Tax Code issue, and could be corrected, albeit over a matter of time; so—and these are just observations—I don't know whether it gets us any further toward a solution, but I think that we are still trying to find some way that relates not just to the industry as a whole.

I think that would be throwing us right back into the 1959 act, and saying you guys get *x*-percent of the tax, divvy it up among yourselves the way you want, and we would be abdicating our legislative responsibility.

Other than that, I don't have an answer. There is a great deal of disagreement, and I hope that over the next 6 weeks or so, we can find something that seems to be equitable; that we can all defend in a rational sense, and I cannot see us coming to that, absent at some point picking a number.

The idea of this triple-headed thing we used as an adjuster was merely an attempt to say once we pick that additional number, which will be a political decision, from then on, let's let them float for a while with some kind of earnings and relationship to the economy as a whole, so we don't have to legislate it every year, as your segment gets out of balance as perceived by yourself or your opponents, the stocks.

We hear your complaints and your concerns, and we will continue.

There is no possible way, short of suggesting that you all convert to stocks, which would simplify our lives, and you may be suspecting that that is what I have in mind for you, but that is not the case.

It does complicate it because of the elusiveness of calculating your operating gains relative to calculating that of the stocks.

You have been patient with us, as we try to learn our way through the complexities of your industry, the accounting, and if we continue to work at this, we will find a way that is—it won't be acceptable to all segments of the industry, but I think generally people will have to say it is rational; and then the issue, I would rather argue over how much. I am comfortable in that arena, and this particular member of the committee probably will withdraw from the debate at that point.

I think people generally today are suggesting that we can deal with that 25 percent factor and the testimony was, we don't want to throw that away until you see what the process is going to yield. I have a hunch that someday we will be arguing whether it will be 25 or 40 percent, and that is a political decision. As the balance, ought it to be 50/50, 40/60? Once we figure out how to calculate it—again, that is a political decision—we will all participate in that. You all have done a marvelous job of politicking here.

I hope we can get the structure down so we are not arguing apples and oranges when the time comes to arguing how much.

I look forward to that argument.

Mr. Moore?

Mr. MOORE. Thank you, Mr. Chairman.

I have several questions.

I would like to thank Mr. Garber for his many months of working with the committee. It has been very helpful, and we appreciate that.

Gentlemen, we all share the problems with return on equity. We fully realize additional work that has to be done.

I certainly thank Mr. Creedon for his comments. He has brought us another approach, and certainly we will consider that as well.

I would like to ask Mr. Creedon, if I may, is the issue the amount of money being raised by the equity formula, or the formula, itself? We are led to believe maybe there is an imbalance on this, and let's assume instead of that 23 percent, it was knocked down to 15, and suddenly we found that your tax picture was not changed at all from what it would have been. Would you be in favor of this approach, or would you still oppose it?

Mr. CREEDON. I would not be in favor of it. It seems to me that the level of tax and the approach are two different issues. I think the level of tax is too high.

However, if you reduce the 23 to 15, you still have the same kind of inequities and uneven impacts on the taxation of particular companies.

For example, I mentioned the comparison between Metropolitan and Prudential. The tax that one or the other paid would depend on its surplus and not on its gain from operations after dividends.

And there are substantial differences between companies during any year, in gains from operations, but the tax would be fixed at the outset because of the way mutual companies operate, as the Chairman said, with redundant premiums.

As they operate, the tax would be fixed as a minimum tax on most, if not all mutual life insurance companies. So, the level, whether it was 23 or 15 percent or as Mr. Bell in his paper suggested, a tax of 1 percent, I think Mr. Chapoton, in his testimony this morning, said what we should really look for is a sound conceptual basis for a tax.

What I am saying is the way mutual companies operate with premiums that are taken in excess of what they expect them to be——

Mr. Moore. Let me ask you this question: In reading your testimony on page 5, you make the statement:

> If mutuals had a dividend allowance comparable to the level of dividends paid by stock companies to their stockholders, we believe this would be a rational basis for the ownership differential.

Well, you are asking us to contrive or put together an average dividend allowance comparable to level dividends paid by stock companies. To me this is not a whole lot different from trying to put together an average return on equity of stock companies that we impute to mutuals.

Mr. Creedon. Well, what I am suggesting, sir, is that you limit the amount of dividends that a mutual company could deduct.

Mr. Moore. I understand that. But I am asking, if you would, for you to comment on the difference.

Mr. Creedon. Well, I think the difference is based on what I understand to be the argument of the stock companies. The stock companies are saying when we pay dividends to our stockholders and those dividends are paid with after-tax dollars.

And if we let mutual companies pay dividends to their policyholders with before-tax dollars, we create an inequity. So, what I am saying is, let's look to the actual experience of the stock companies in paying dividends to their stockholders and let's translate that in a dividend disallowance for mutuals.

The problem we are having here is in identifying what part of the dividends that mutual companies pay to their policyholders are equivalent to the dividends that stock companies pay to their stockholders.

We say let's look at the experience and translate it.

Mr. Moore. It is precisely what we do on return on equity. Look what the average return on equity is to stock companies and impute that to mutuals. You are saying the same thing, and using a different measurement.

Mr. Creedon. No, sir. The problem is that the committee is proposing a minimum tax, which is based on equity, but it is a fixed tax the way mutual companies operate, it is going to be a fixed tax that mutual companies will pay. It will not be a tax that is based on gain from operations.

What I am suggesting is a minimum tax based on a gain from operations before dividends.

Mr. Moore. Well, the point I am trying to get you to comment on is this committee or the Congress or whatever, has got to come up with an ownership differential and it is going to be a judgment call.

Mr. CREEDON. Yes, sir.

Mr. MOORE. Your judgment call is no more perfect in defining what the company actually does than is the return on equity judgment call that has tentatively been made. Both requiring an experience from the stock industry translated to the mutual industry.

Mr. CREEDON. But what I have tried to indicate, Mr. Congressman, is that the judgment call and the proposal is one which produces unfair, inequitable, uneven taxes on companies just because of the level of their surplus, because of the way mutual companies work.

Now, that would not be the result of the proposal that I indicate. What I am suggesting if you follow through would be that mutual companies would be able to deduct 92 or 92.5 percent of the dividends that they pay to their mutual policyholders where stock companies would be able to deduct 100 percent of the dividends that they pay to their policyholders.

Mr. MOORE. I understand. I am trying to get to the point of the measure. I understand how your system would work and what essentially the stopgap is.

Mr. CREEDON. May I clarify my view in this respect. If you took your measurement, which is a return on equity and you said, now, if I translate this return on equity into a disallowance of dividends it would come out to 7.5 percent. That would be acceptable. It would not be a tax on surplus.

Mr. MOORE. That is what Mr. Van Fossan testified to today. What we are trying to accomplish is not a tax on equity. That is your terminology, not ours. What we are trying to find out is what is your income.

There has got to be a certain kind of income level or something as a percent of your equity. That is what we are trying to get at. It may be imperfect and we are trying to perfect it.

Mr. CREEDON. I think, Mr. Moore, that you could get at it by a single phase approach. In other words, if we were to pay a tax based on a single phase approach without looking at the minimum tax, we would pay a tax of $230 million. Now what I have suggested is by making a dividend differential here of 7.5 percent, we would pay an additional tax of $26 million.

Mr. MOORE. I am not talking about aggregate tax dollars. I started out by asking the question, if we can adjust the equity formula to get it down to where you were happy with the tax level, what is the difference, and that is when we launched off the second series of questions.

Let me ask you one last question, and that is, is there a point beyond which you can't reduce your surplus to avoid a return on equity concept? You seem to indicate that that is what the companies are going to do, reduce their surplus and reduce their taxes.

Is there a point beyond which you can't do that?

Mr. CREEDON. I would hope they would not do that. I would hope there would not be a tax and economic incentive to do it and we have at least some indication that in another situation where there was a comparable tax that was done, I think it inadvisable to provide a tax and economic incentive for companies to do it.

I would hope they would not do it. I would hope in my case, I would not do it.

Mr. Moore. Well, we are concerned about that. We don't want to send out the wrong kind of economic incentive. My question is, as a practical matter, can they do it? You start reducing your surplus, aren't you going to run afoul of the insurance commissioners in the States who are going to say, you are not keeping your surplus levels up?

Mr. Creedon. There is a level of discretion as to what the surplus should be. It is discretionary. There are some companies that have a surplus of 10 or 11 percent. In New York State, you cannot have more than 10 percent.

That is a statutory limitation. I think among the big companies they tend to have something below 5 percent, but there are a number of companies that have 10 percent or more.

It is a judgment call on how you want to manage the business. I agree with you. I think it would be inadvisable to get your surplus down below a certain level, but life insurance companies do go insolvent.

Baldwin United is a good example. It happens.

Mr. Moore. They wouldn't reduce their surpluses down to the point where they went insolvent to save on taxes.

Mr. Creedon. No, I would hope not.

Mr. Moore. Thank you.

Chairman Stark. Could I just follow along on that? On what basis is the minimum statutory level of surplus determined?

Mr. Creedon. There is a statutory basis for the formation of new companies.

Chairman Stark. What about continuation of existing companies?

Mr. Creedon. I don't know of any such requirement. There is a statutory basis when a company is formed and in the case of life insurance companies, I know of no substantive——

Chairman Stark. Can the company run at 1 percent or one-half of 1 percent of surplus?

Mr. Garber. Well, the supervisory authorities have certain standards and they certainly would begin to look at a company's operations at that surplus level.

Chairman Stark. Then the mandatory reserves that were established by the State commissioners, in the opinion of the State commissioners, are all that is required for the protection of the policyholders?

Mr. Martin. In our State, at least, sir, this is a judgment decision made by the insurance commissioner. If you asked me when he last enforced that judgment, not in the memory of man.

Chairman Stark. Is that true in most other States; is it true in California?

Mr. Martin. I believe so.

Mr. Creedon. It, interestingly, is not true in the casualty business.

Chairman Stark. But basically, what I am saying is that the reserves that the various commissioners require are the ones that are determined to adequately protect the policyholders. They may like to have more surplus, but there is nothing statutory that requires you to have surplus above those reserves.

Mr. **Creedon**. Well, that is true, but suppose you had 15 percent of your assets invested in common stock and the common stock went down 40 percent.

Chairman **Stark**. Is there any difference between the statutory reserves for a high surplus company and a low surplus company?

Mr. **Creedon**. No.

Chairman **Stark**. So, I think what you are beginning to get to is that the adequacy of reserves to protect policyholders has been dealt with, and that any reserves above that, that is, surplus, as you said, are a management call or a judgment factor, and I suppose that that ought not be of any concern to us.

Mr. **Creedon**. But if we didn't have any, we wouldn't pay any tax, I guess. Maybe it should be considered.

Chairman **Stark**. Well, I suspect you would.

Mr. Guarini?

Mr. **Guarini**. I thought when you start a company, that you had to have so much reserve against how many times you would write against that reserve. After you got going, there is probably a great deal of liberality, but aren't there national standards?

Mr. **Creedon**. In the casualty industry, yes, there are. They relate the premium volume to your writings. In the life insurance business, as I understand it, each State has a requirement with respect to capital and surplus when a company is formed, but there is no formal statutory requirement with respect to the level afterwards.

Mr. **Guarini**. You refer to this 23 percent as a minimum tax. Is that how you feel?

Mr. **Creedon**. That is the way it would operate on a mutual life insurance company, yes, sir.

Mr. **Guarini**. Because of the way you operate?

Mr. **Creedon**. Because of the way mutual life insurance companies operate and take in redundant premiums it would be a minimum tax on our surplus.

Mr. **Guarini**. Because you give away so much more of your income in the form of dividends to the policyholders?

Mr. **Creedon**. Yes, sir. We take in excess premiums and then we give it back, yes, sir.

Mr. **Guarini**. So, what this would do would be to minimize what you have been doing?

Mr. **Creedon**. Well, it could have the effect of pointing in that direction and I think the chairman suggested that this might be a possibility.

In other words, you might force the companies to take less excess premium than they otherwise would take. It might push you in that direction.

Mr. **Guarini**. What is the effective tax rate on your Metropolitan Life Insurance Co., sir?

Mr. **Creedon**. I don't know that anyone can define effective tax rate. We have paid in the last 5 years an average of about $200 million in taxes. We paid approximately $200 million in 1982, but how you describe that as an effective tax rate, I don't know, sir.

Mr. GUARINI. Now, if this formula went into being against the 23 percent tax rate on equity, how much more would you be required to pay?

Mr. CREEDON. We would pay about $400 million instead of $200 million. Whereas if we were a stock company, we would pay about $230 million.

Mr. GUARINI. You mentioned before about paying on the equity of a company in New Jersey. Many States, New York, New Jersey actually have two forms of taxes on the corporate sector, as you know. One of them is on net worth, which does seem to be intrinsically unfair and the other is on the net income.

You can make no money at all for that year in whatever corporation you are in and still not be required to pay to the State of New York or New Jersey a sizable income tax. Of course, that is even a worse kind of a tax because that is truly a tax on your net assets.

Mr. CREEDON. The normal tax in most States is a premium tax. In other words, you pay 2 percent, say, of the premiums that you receive and that is a gross tax. It is a gross tax. It is not an income tax. It is just a tax on premiums.

Mr. GUARINI. So all we are trying to get out here is trying to find a formula whereby you would limit the amount of dividends that you could give to your policyholders tax-free. Do you find that objectionable?

Mr. CREEDON. No, sir, I do not. What I am suggesting is that the approach that the committee has developed because of the way mutual companies operate serves as a minimum tax on surplus. It will be the tax that mutual life insurance companies pay and will be based on the surplus and it will not be based on a gain from operations after dividends.

Mr. GUARINI. Just lastly, if this 23 percent went into being, would you be paying actually more tax or would you be enabled to give less tax-free dividends to your policyholders?

Mr. CREEDON. Well, probably both. In other words, we would pay more tax and the net effect of that in all likelihood would be that we would pay less dividends.

Mr. GUARINI. And you object not only to a tax on equity, but you also object to any definition of surplus?

Mr. CREEDON. No, sir. What I was trying to suggest was that if we are trying to get at an ownership differential, which would require mutual life insurance companies to have less than a 100-percent deduction from gain from operations for payments of dividends to policyholders, that we define that in a way that is related to what the stock companies are saying is their problem, and they are saying that they are paying dividends to their stockholders with after-tax dollars and we would be allowed to pay dividends to our policyholders with before-tax dollars.

And all I am saying is that we should try to convert the level of dividends that they pay to their stockholders to a limitation on the dividends that we can pay to our policyholders.

So, I am not saying there should not be a dividend differential. In fact, in the proposal that I mentioned, there would be a dividend differential in the case of Metropolitan that I mentioned of about $26 million.

In other words, 10 percent of the tax we would otherwise pay.

If we were taxed just as a stock company under the stock proposal, we would pay $230 million of taxes.

Now, if you imposed on that the ownership differential that we suggest, we would pay $256 million. And so, we think that is a reasonable differential. In other words, there is 10 percent more tax to recognize the fact that the stock companies are paying some of their earnings out in the form of dividends.

Mr. **Guarini**. Well, we could always vary the figure. What I am trying to say is your principal objection, we focus in on it and it makes you less competitive with the stock companies, so the principal problem turns out to be that you spend a few more dollars in income tax?

Mr. **Creedon**. We have three principal problems. One is the tax that the proposal would produce. Second is the approach to a minimum tax here in the case of mutual companies would not be a minimum tax. It would not operate as a minimum tax. It would operate as a tax that mutual life insurance companies pay and it would be a tax based on surplus.

In other words, as I view it, it would be a wealth tax, not an income tax.

Mr. **Guarini**. All right, thank you.

Chairman **Stark**. Mrs. Kennelly?

Mrs. **Kennelly**. No questions.

Chairman **Stark**. Mr. Jenkins?

Mr. **Jenkins**. Thank you, Mr. Chairman.

I thank the panel for your testimony. I will be frank in saying that I had thought I was moving along fairly well in understanding the plight of the mutual companies, but, Mr. Creedon, you seem to be taking the position that this entire proposal is just wrong from a tax policy standpoint and, apparently, philosophically as well. Is that right?

Mr. **Creedon**. Not the entire proposal. We fully support that part of the proposal that is a single phase tax. In other words, in our case, $230 million of taxes would be what we would pay if it were a single phase tax.

What I am objecting to is that in addition to that single phase tax of $230 million, they are saying, in the case of mutual companies, you have to pay a minimum tax which is based on your surplus and that is without regard to our gain from operations after dividends.

Mr. **Jenkins**. Well, have you ever paid taxes on gain from operations before?

Mr. **Creedon**. We are paying it under stopgap, yes, sir. That is the basis of the tax under stopgap, is a gain from operations tax.

Mr. **Jenkins**. And that will last how many years?

Mr. **Creedon**. Well, for 1982 and 1983, and, as Mr. Garber mentioned before, under the 1959 act, we essentially paid a tax on our investment income.

Mr. **Jenkins**. You didn't pay tax on gain from operations under the 1959 Act, did you?

Mr. **Creedon**. In theory, it did, but there was a limitation on the deduction of dividends which was related to your investment income and the effect of the 1959 act, when it was first passed, sir, was that we could not deduct more than 90 percent of our dividends in determining the gain from operations tax.

Mr. JENKINS. I understand your concern, but it appears to me that we may have the possibility of a framework that, with some adjustments, could work, but from your testimony, it would appear that in your own view this is simply the wrong approach to take, because it is a tax on wealth.

Mr. CREEDON. Well, yes, sir. I tried to respond to Mr. Moore, and I guess I wasn't very successful, but what I was trying to say was that you can develop it a number of different ways, an approach that would operate to limit the amount of deduction of dividends.

In other words, instead of getting 100 percent, we can get 92.5 or 90 or a stopgap now provides 77.5 percent. There are a number of different ways of doing it. All I am saying is that the way the committee has done it is conceptually not the way to go.

Mr. JENKINS. There is a provision in the law known as the net worth theory. If you have a person with $200 million, and you don't know how they got their money, you suddenly go after them and impute income to them. Is that approach very different?

Mr. CREEDON. Well, to some extent I think that is the way this would operate.

Mr. JENKINS. So you would disagree with the net worth principle of Federal tax law?

Mr. CREEDON. It is a way of trying to find people who don't pay their taxes.

Mr. JENKINS. As an old defense lawyer, I may agree with you. This is not a novel approach. You do imput income.

Mr. CREEDON. I am saying, if you impute income, it is not our real income. In other words, if this is to be an income tax, let's look at our gain from operations after dividends, and if you want to limit the amount that we can deduct on dividends, OK.

But the way this system would work, it wouldn't be that way. It would simply be a tax on our surplus. I don't think it was intended that way by the committee or the staff or anyone else, but the fact of the matter is that the way mutual companies operate, that is what it would be, sir.

Mr. JENKINS. I am confused because I don't have your expertise in life insurance tax law. You say this is not a tax on gain from operations, but 10 years ago, wouldn't you have said, "Don't tax me on gain from operations, tax me only on investment income"?

Mr. CREEDON. No, sir, I would not have. One of the major problems with the 1959 act is that it is a tax on investment income. In other words, it doesn't tax your gain from operations. You could have an investment income and have lost money, as Bob Beck mentioned this morning, $300 million on his group health line and still pay a tax and get no benefit from the fact that you lost that $300 million.

Mr. JENKINS. I think my time is up, and I want to thank the panel for your testimony, each of you. The reason I only questioned you, Mr. Creedon, was because your testimony was a bit different from what I had heard from other mutuals.

Thank you very much.

Mr. MARTIN. Congressman Jenkins, may I make a response to one of the questions you made? I know that Mr. Creedon was very specific and did not state that all mutual companies felt as he did. I am sympathetic with the problem that many see in a surplus approach, but had you asked me if the Massachusetts Mutual could live with the present proposal, if the rate were brought down significantly to the realms you were talking about, I would have responded yes.

Mr. **Jenkins**. Thank you, Mr. Martin.

Chairman **Stark**. Gentlemen, thank you very much. I am sure we will see a lot of each other in the weeks ahead.

I appreciate your being here with us and we will talk some more as we try and iron out this problem.

We have saved the best for last, as is usual in these hearings. We now have a panel of the National Association of Life Underwriters represented by Mr. Alan Press, the trustee, and the Association for Advanced Life Underwriting represented by Albert J. Schiff, CLU, associate vice president of the association—the gentlemen whose tireless efforts make all these billions of dollars of assets possible so that we can turn around and tax them. I thank you very much for your patience and we appreciate it.

As Mr. Press is listed first on the witness list, we will let him proceed. We have your statement, I believe, and without objection, it will appear in the record in its entirety. You may summarize it or extract from it as you see fit.

STATEMENT OF ALAN PRESS, TRUSTEE, THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, ACCOMPANIED BY JAMES DOUDS, SENIOR VICE PRESIDENT

Mr. **Press**. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am a trustee of the National Association of Life Underwriters. I am accompanied by Mr. James Douds, senior vice president of our association.

I am privileged to represent our 127,000 members who sell and service life and health insurance to families and businesses all across our country.

Mr. Chairman, our membership is almost equally divided between representatives of stock life insurance companies and representatives of mutal life insurance companies.

As agents, we do not feel that we have the technical expertise necessary to comment on the provisions relating to the taxation of life insurance companies. We do believe that any legislation that is enacted should be fair to all segments of our industry. It should not competitively favor stock companies or mutual companies. It should not favor any particular type of product to the detriment of any other type of product.

With regard to the definition of life insurance, we share the concern of some who believe that the current tax law allows investments to masquerade as life insurance in order to take advantage of the unique tax treatment of our product, and that some products have been designed to take maximum advantage of the tax deductibility of life insurance policy loan interests to create so-called arbitrage products.

We believe that the Stark-Moore definitional approach to curing these perceived problems represents an encouraging start in the process of finding a solution. However, we are not sure that the particular formulas suggested will produce optimum results, particularly with regard to the traditional policy forms.

Mr. Chairman, our association's most serious objection is to the proposal to limit the tax deductibility of interest on loans of the cash value of permanent life insurance. We believe that the enactment of such a proposal would seriously reduce the sale of permanent life insurance, so important to the financial security of America's families and business and so to our economy and to our society.

Permanent life insurance allows American families and businesses to guarantee their long-term financial security. Permanent life insurance is more than death benefits. It provides living benefits as well and to the extent that our industry is successful in selling permanent life insurance, benefits also flow to our society.

Families will stay together, businesses will stay in business. Kids will go to college, mortgages will be paid off, and payrolls will be met.

The availability of the tax deductibility of interest on loans, of life insurance policy cash values through the flexibility it offers, facilitates and motivates the purchase of permanent life insurance in amounts disproportionate to the amount of borrowing that actually takes place.

If the purpose of limiting the deductibility of policy loan interest is to cure the abuses inherent in so-called arbitrage products, we believe that it is an unnecessarily draconian method of doing so. Rather, we believe that the key lies in establishing a proper relationship between the face amount of the policy and the combination of premiums and return on premiums or net amount at risk.

The requirement of a sufficiently high net amount at risk should prevent accumulations that encourage arbitrage, inordinate positive cash flow, and would seem to be a much less onerous approach to curing the problem.

Disallowing the interest deduction to a policyholder who borrows on life insurance to send a child to college would be grossly inequitable unless the same harsh treatment was applied to a loan made for a similar purpose from a bank.

Finally, Mr. Chairman, we wish to comment on the proposal to reduce basis in a life insurance contract on surrender by the value of the pure risk element of the policy. Once again, we believe enactment of such provision would seriously reduce the sale of our product.

Additionally, we believe that the proposal unfairly discriminates against our product. No other product must reduce basis by the imputed value of its use on sale. We can offer the committee examples of products where no such tax is levied.

Upon recomputation of the example used by Treasury in its presentation to this committee on May 10 with regard to the taxation of permanent life insurance policy on surrender at age 65, using more realistic mortality costs as suggested by Chairman Stark, the results would still be onerous to our policyholders while producing approximately only half the tax Treasury projected in its testimony. Page 14 of our written statement elaborates this point.

Mr. Chairman, once again, we wish to thank the committee on the good beginning it has made on the taxation of life insurance. We urge the committee not to propose legislation that would inhibit the sale of permanent life insurance so vital to the financial security of millions of policyholders our 127,000 members serve.

We therefore urge the committee to reject the proposals for limiting the deductibility of policy loan interest and to reject the proposal that would change the rules governing computation of basis on the surrender of a life insurance contract.

We wish to thank the committee for the opportunity to present our views and would be pleased to answer any questions you may have.

Thank you.

Chairman STARK. Thank you very much, Mr. Press.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS PRESENTED BY ALAN PRESS

Mr. Chairman and members of the subcommittee, I am Alan Press from New York City. My business, like that of my life underwriter colleagues across the country, involves the sale and service of life and health insurance policies to and for individuals, groups and businesses, especially small businesses.

I am appearing here today as the representative of The National Association of Life Underwriters, which is a federation of over 1,000 state and local life underwriter associations. The federation represents a combined total of over 127,000 career life underwriters. Our membership is evenly divided between stock and mutual life insurance companies.

NALU would like to compliment this subcommittee, and especially Representatives Stark and Moore, for the excellent beginning provided by the proposal being examined today. The "Stark/Moore proposal" seems to provide a good framework for discussion and, with the modifications that hopefully will flow from this hearing and consultation in the weeks to come, can provide an equitable, workable system of tax rules to govern life insurance companies and products.

However, while NALU lauds the overall theory and approach embodied in the Stark/Moore proposal, we do have substantial concern over some of this proposal's provisions. We hope that these concerns can be taken into account and that the proposal can be modified as we suggest below, so that life underwriters can become enthusiastic supporters of a life insurance tax bill based on the Stark/Moore framework.

PROVISIONS RELATING TO THE TAXATION OF LIFE INSURANCE COMPANIES

Before examining the individual taxation provisions of concern to NALU, a general comment on the company taxation provisions is in order.

As mentioned at the outset, at the moment the 127,000 life underwriters comprising the membership of the federated associations of NALU are almost equally divided between stock and mutual companies. From that essentially equal division, our position on the taxation of life insurance companies is probably evident. NALU believes the tax laws should be so designed as to favor competitively neither stock nor mutual insurers or their products.

Beyond that, NALU is not in a position to comment on appropriate life insurance company taxation, except to say that life companies should not be called upon to pay more than their fair share of all corporate taxes. We believe this is particularly important today when competition between various types of financial intermediaries is accelerating.

INDIVIDUAL TAXATION PROVISIONS

Life underwriters believe they are qualified to comment on the effect of laws—tax and others—that govern life insurance policies. We experience daily the actual importance of life insurance to the American people. We believe we know first-hand why people buy life insurance, and how they use it.

Our experience teaches that life insurance, especially permanent life insurance, is enormously important to the financial health of the U.S. economy and the American people. It is the economic salvation of widows, widowers and children. It is an important foundation of millions of people's retirement plans. And, insurance provides substantial amounts of the vital investment capital required by the economy.

We are here to emphasize the need for Congress to enact legislation that will not discourage the purchase of permanent life insurance. We believe that to the extent that tax laws make life insurance less competitive or attractive, less will be purchased. To the extent that fewer people are covered, or that people are less than adequately protected, there will be equal harm to families, businesses, our economy and society. There will be increased pressure on government assistance programs, and on Social Security.

It has been asserted by some members of Congress, the Administration, and some interested parties in the private sector that current tax law allows "investments masquerading as life insurance." NALU shares that concern, although we admit to experiencing difficulty in determining exactly where to draw the line. We think the Stark/Moore proposal is a promising beginning to the process of making that determination.

However, in its current form we believe the proposal goes too far. Some of its provisions, in particular the policy loan limit and the calulation of investment in the contract provisions, while seeking to curb abuse, would in our opinion severely inhibit the sale of permanent life insurance. Further, neither provision is required to achieve our mutual goal of preserving unique tax treatment for a unique and uniquely important product—life insurance—while preventing non-protection-oriented investments from enjoying life insurance tax treatment.

LIMIT ON THE DEDUCTIBILITY OF POLICY LOAN INTEREST IS NOT AN EFFECTIVE WAY TO CURB ABUSES AND WILL HURT PERMANENT INSURANCE SALES

NALU is extremely concerned that the Stark/Moore proposal's limit on the deductibility of interest on policy loans will seriously inhibit the public's ability and desire to purchase adequate permanent insurance protection.

The ability to borrow on a life insurance policy is a major factor in the decision to purchase an adequate amount of permanent insurance. The basic nature of life insurance is its operation as a long-term device that guarantees financial security at retirement or in the event of premature death. As such, it requires a long-term financial commitment from the policyholder. Many—in fact, most—prospective policyholders can with comfort determine that the annual premium for the amount of insurance they need is affordable now and in the foreseeable future. But they also worry about the possibility of financial hard times that happen, at one time or another, to most of us. The ability to borrow from their policies, in the event of those hard times, becomes a key factor in their decision to make the long-term financial commitment required. And it is important to note that in many cases the sale is made because of the option to borrow, but that actual borrowing may never occur.

All life underwriters can cite multiple examples of the near-daily working of the importance of the policy loan feature. For now, let this one illustration suffice. Consider the 35-year-old man who has agreed that he needs a $200,000 permanent policy, and that he can afford it—now. However, he's less convinced that the premiums required will continue to be affordable for the 30 years or so that premiums will be paid before the major planned-for event, retirement, occurs. He is inclined to purchase only a $100,00 policy so that he will be certain to be able to keep his policy in force. But, the knowledge that should those financial hard times occur, he can borrow from his policy and deduct the interest on the loan and thus keep the policy in force convinces him to go ahead with the purchase of the entire amount of coverage he needs.

In actual fact, this policyholder, like most policyholders, borrows only minimally or not at all from his policy. But the policy loan feature has motivated a decision that would not have been made in the absence of that feature. Limiting the ability to deduct interest takes away one reason to buy permanent insurance. If you multiply this one example by the thousands of times it happens each year, the enormous impact of a limit on the deductibility of interest on policy loans becomes frighteningly clear.

Consider the multiple effect. Because the policy loan feature motivates the purchase of permanent insurance vastly more often than actual borrowing results, its limitation acts to depress vastly more than tax-leveraged borrowing. In the aggregate, such a limit would result in a yet more underinsured population, creating yet greater pressure on expensive government social welfare programs. Moreover, it would substantially reduce the inflow of capital to the nation's economy. With our national savings rate at only 3 percent, can America afford such a drastic reduction in capital-developing capacity? Can our deficit-ridden federal budget bear the pressure for more social programs, or greater levels of benefits under Social Security? Yet, to the extent that this provision or any tax law acts to inhibit the private sector's ability to provide financial security and capital formation, it creates such pressure on the federal government.

The Stark/Moore loan limit proposal has other harmful, unintended potential effects. We believe it would stimulate lapsation of coverage among current policyholders who purchased their contracts on the basis of their ability to finance them. For these people, the Stark/Moore proposal represents a choice between maintaining a policy they may not be able to pay for without the deductibility of interest on policy loans, or surrendering their policies. This is a harsh result. For some, it will mean having to replace existing contracts with lesser, inadequate amounts of permanent coverage, and the resulting need to pay acquisition costs for the new coverage. For others who are now uninsurable the result is even worse. These people do not have the option of buying less new coverage. Their choice is limited to surrendering their financed insurance and living with an unmet insurance need, or somehow finding a way to pay the extra from other sources of revenue.

Further, financed insurance is commonly found in nonqualified deferred compensation plans. These plans provide retirement income. Many such plan sponsors need to borrow from their life insurance policies in order to maintain the plans. Limiting or eliminating their ability to borrow represents a threat to the plans' continued existence. Termination of the plans will result in more people facing retirement with insufficient income which in turn will put greater stress on government assistance programs and Social Security.

DEFINITION OF LIFE INSURANCE

It would seem then, that Congress may be faced with a classic choice. It can decide to act to prevent any arbitrage problem that may be perceived, or it can accept the occasional misuse as a necessary byproduct of preserving the greater good—the loan feature's encouragement of security and capital. Remember that the practice's potential is limited to economic conditions of high interest rates that occur in relatively infrequent cycles. Will Congress, to dredge up that most hackneyed of expressions, throw out the baby with the bathwater?

NALU believes Congress does *not* have to make such a choice. This is because in all likelihood the definition of life insurance can itself curb the arbitrage problem.

DEFINITION OF LIFE INSURANCE PROVIDES APPROPRIATE FRAMEWORK

NALU supports the approach taken by the Stark/Moore proposal in defining life insurance for tax purposes. The definitional approach, designed to identify a crossover point where a life policy becomes more heavily investment-oriented than protection, accurately pinpoints the elements to be restricted. The key to a successful definition is the relationship between the policy's face amount and the combination of premium and return-on-premium accumulating inside the contract. In other words, the critical element is the net amount at risk, or insurance element. NALU believes that the Stark/Moore proposals's definitional provision is an appropriate framework for calculating the crossover point by requiring a minimum level of insurance, or net amout at risk, in a contract at all times in the policy's life.

While NALU approves the proposal's general structure, we are not fully convinced that its specifics will identify the correct crossover point. We urge this subcommittee to recall the need to avoid discouragement of true protection-oriented life policies. As drafted, the proposal may go too far, causing some contracts that provide the protection and security of life insurance to fail the definitional test. Further study of the proposal's effect on all kinds of permanent life insurance policies is required before a judgment as to its specifics can be made.

Life underwriters share Congressional concern that life insurance not be permitted to act simply as a tax shelter for current investment yields. But at the same time, we are concerned that the effort to curb abuses not unduly curb innovation or result in disqualification of true insurance contracts. Such a result would cripple the product's competitive position in an increasingly sophisticated financial planning marketplace. It would depress the amount of permanent insurance in force which would in turn bode ill for the security of our nation's families, businesses and economy.

We believe that the specifics contained in both the Stark/Moore proposal and the tests contained in IRC Section 101(f), as they would operate if extended to level premium contracts, should be studied as possible ways to draw the appropriate line. Or, perhaps the most appropriate test would be somewhere between these two definitions.

NALU believes that the results of the actuarial calculations required to establish the appropriate definition of life insurance will prove that the so-called arbitrage products will fail to provide sufficient inside buildup to allow the arbitrage practice. If cash values were high enough to allow the practice, the policy's ratio of cash value to face amount would disqualify it under the definitional tests.

We are currently in the process of analyzing an example of an arbitrage policy which some members of the subcommittee have deemed abusive. We will test it under the definitions of flexibile premium contracts found in TEFRA and the definitions in the Stark/Moore proposal.

PROVISION CHANGING MEANS OF COMPUTING INVESTMENT IN A CONTRACT WOULD ENCOURAGE EARLY SURRENDER, REPLACEMENT AND TREAT INSURANCE UNFAIRLY

The Stark/Moore proposal contains a provision which would require policyholders, on surrender, to reduce their basis in their policies by the cost of term insurance. This requirement is unfair and would cause early surrenders, replacement and a net decline in the amount of permanent insurance in force.

No other form of property is taxed according to rules that do not allow basis to include the full cost of acquiring the property. One example is a home. The owner of a home is not required to reduce his or her basis in the home by the imputed rent—the economic value of having lived in it between purchase and resale. It is true that purchases and sales of owner-occupied homes are accorded very favorable tax treatment, perhaps the most favored available tax treatment. But the social purpose of that favored treatment—shelter—is not much, if any, more important than the social value—protection—underlying life insurance. And, the tax treatment of life insurance is by no means comparable to the tax treatment of owner-occupied homes. Life insurance gains are not taxed at a capital gains rate, as are gains from homes. There is no exclusion for older people who surrender life policies, as there is for older home sellers.

Further, we can think of no property which must take an imputed value of use into account in determining basis. For example, the person who bought and drove a car that later became a much more valuable classic car need not reduce his or her basis in the car by a value imputed to the use of the car between its purchase and resale. Similarly, a person who bought a painting that later turned out to have appreciated in value would not have to impute a value to enjoyment of it during his or her years of ownership. Instead, the basis would be the actual cost of it at the time of purchase.

Thus, it is unfair to require life insurance owners to reduce their basis in their policies by the value of the term insurance protection.

Beyond its inequity, such a requirement would have widespread, harmful consequences. Policyholders would be encouraged to surrender their policies before the cash values accumulate to a point of taxable gain. Currently, most policies show no taxable gain until between the 10th and 20th years of the policy's life. The reduction of basis would accelerate the point at which taxable gain occurs, and stimulate early surrender and, in many cases, replacement with another policy to keep insurance protection in force. The provision would act as an incentive to purchase term protection rather than permanent protection, whether it be by way of term insurance or by way of regular, well-timed replacement of permanent policies.

In addition, such a tax rule would be inconsistent. For example, the value of life insurance in a pension plan is subject to individual income tax, based on the economic benefit accorded the individual by virtue of the death benefit. The so-called PS58 cost is the value added to the pension plan participants' taxable income. But, when retirement occurs, the taxable income of the retiree is reduced by the amount of PS 58 value on which income tax has been paid. Thus, insureds whose coverage is within a pension plan are not reducing their basis in the insurance by the cost of insurance protection. It is unfair and inconsistent to treat insurance outside a pension plan any differently.

The effects of this provision are substantial. The example below shows the difference in taxable gain, using both the lowest available term rate from one company and the term rates assumed by the Treasury Department in its testimony on this idea at the May 11 hearings before this subcommittee.

Policy issued at age 35, face amount $100,000, annual premium $1,345. Surrender at age 65.

	Current method	Proposed method	
		Treasury term rates	Lowest available term rates
Total premiums	$44,813	$44,813	$44,813
Less mortality charge		22,942	5,665
Net premiums paid	44,813	21,871	39,148
Cash surrender value	51,625	51,625	51,625
Investment income	6,812	29,754	12,477

In the best case, such a rule nearly doubles the tax liability facing the policyholder. (But it should also be noted that actual revenues from this provision will be far less than the projections resulting from Treasury's figures.) It is not hard to understand why such a change in the law governing computation of basis would act as an incentive for early surrenders and replacement, or purchase of term insurance rather than permanent insurance. And once again, it is permanent insurance that provides security for families and other beneficiaries of the death benefit. (A 1982 study shows that less than 1 percent of all term insurance results in a death claim. It is permanent insurance that provides retirement security and at the same time helps ease the pressure on Social Security and other government programs. It is permanent insurance that generates the substantial capital—$38.3 billion from life insurance companies in 1981 alone—so critically necessary to a healthy economy.

GROUP TERM LIFE INSURANCE PROVISION REQUIRES CLARIFICATION

The Stark/Moore proposal includes a somewhat cryptic provision concerning the extension of antidiscrimination rules to retireds under a Section 79 group term life insurance plan. NALU cannot react to this provision, or provide input as to its effectiveness or necessity, because it is unclear what the provision means and intends.

We request clarification of this provision. What result is it intended to achieve? How would this provision work in its attempt to accomplish that result?

CONCLUSION

The Stark/Moore proposal represents a sound framework, but policy loan interest deduction provision, reduction of basis provision are objectionable, harmful proposals.

In conclusion, NALU again congratulates Representatives Stark and Moore for a proposal that, with modification, has the potential to create an equitable, workable structure for the taxation of life insurance companies and products. We support the approach taken by the proposal's definition of life insurance and offer our assistance in refining its specifics. However, we recommend dropping the proposed limit on the deductibility of interest on policy loans. We believe that the abuses at which the provision is aimed can be solved by a properly-drafted definition of life insurance. Finally, we also recommend dropping the proposal's change in the rules governing computation of basis in a life insurance policy. The proposed changes unfairly treat life insurance differently than other forms of property, and would encourage a decrease in permanent insurance coverage.

Thank you.

Chairman STARK. Mr. Schiff.

STATEMENT OF ALBERT J. SCHIFF, ASSOCIATE VICE PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING, ACCOMPANIED BY GERALD H. SHERMAN, COUNSEL

Mr. SCHIFF. My name is Albert Schiff and I am a professional life underwriter. I appear before you as associate vice president of the Association for Advanced Life Underwriting.

Fred Kissling, president of AALU, testified at your May 10 hearings. He has asked me to express our thanks for your invitation to testify and to present our views today.

I am accompanied by Gerald H. Sherman of the Washington, D.C., law firm of Silverstein & Mullens.

Our 1,100 members are vitally concerned with the ways in which the American life insurance policyholder is subjected to tax. We are dedicated to the proposition that permanent life insurance performs a socially vital function which must be preserved.

You will be glad to hear we do not presume to offer guidance on the tax structure of life insurance companies. Our focus will be on the individual taxation portion of the proposal.

We emphatically believe that the adoption as proposed of either the limitations on interest deductions for policy loans or the calculation of tax basis of policy surrenders or withdrawals: one, will significantly impact and decrease capital formation and capital preservation for American families and businesses; two, will negatively affect the livelihoods of more than 100,000 professional life underwriters in the United States; three, will negatively affect the capital structure of the entire life insurance industry; four, all without meaningful gain, in fact, most likely with significant reduction in Federal revenues, and with little technical or conceptual basis.

Interest on policy loans has been deductible for many years. We understand that the subcommittee perceives that there have been certain abuses of the arbitrage available to certain life insurance vehicles under the current tax system.

However, these so-called abuses based on your perception of the congressional intent of Federal tax policy has already been corrected through: one, the enactment of the carefully established guidelines of section 264 of the Revenue Code; two, and the various States enacting the guidelines for insurance companies to charge variable loan interest rates based on independent indices which assure that those rates remain comparable with current market rates.

This has had a dual benefit, protecting insurance company reserves against disintermediation, and providing less incentive for the policyholder to borrow at statutorily restricted, artificially low policy interest rates and reinvesting at higher current market yields.

The balance of the perceived abuses centers on cash heavy investment contracts which masquerade as life insurance vehicles and which are designed specifically to take advantage of this tax arbitrage.

In principle, the recommendations in the committee print with respect to the definition of life insurance, if adopted, would eliminate the source of this concern, and obviate the need for any further limitation on policy loan interest deductions in order to curb the perceived abuse.

The interest deduction proposal, instead of adjusting a tax inequity, in fact would practice a substantial discrimination on life insurance loans. No other property which develops long-term equities or which provides for loans which bear on personal needs, living requirements or business requirements faces this kind of limitation.

To claim that a deduction for interest on a life insurance loan is favored because it borrows against cash values which earn tax-free income is inaccurate. Substantial taxes are raised at the life insurance company level, which will presumably become larger at the conclusion of this legislative process.

Whether those taxes are collected at the company level or the policyholder level in terms of Federal revenue is not relevant.

Even now, section 264 imposes special limitations which are not applied to any loan other than a life insurance loan. We contend that there is no need to, and ask you not to, discriminate further against life insurance.

The substantial lapse of existing permanent life insurance, and discouraging the purchase of new permanent life insurance will impair the creation of capital reserves. Term insurance creates no capital reserves for the purchaser; very little capital for the insurance carrier; substantially less security for the policyholder; and little coverage will be in force to create new capital, or preserve existing capital, or provide needed liquidity at the death of the insured.

Subsequent to our submitted written testimony, more detailed statistics reveal that approximately 25 percent of the current life insurance being purchased with face values in excess of $100,000 represents permanent life insurance coverage. Assuming that 50 to 60 percent of that coverage would still be purchased if the interest deduction were not available, sales of cash value life insurance would be reduced by approximately $40 billion. This would have devastating social consequences.

AALU also opposes the recommendation that an assumed term portion of a permanent policy be imputed and subtracted from the total premiums to arrive at a net basis for purposes of measuring gain on surrender. If adopted, this will result in similar negative economic consequences to those we have noted with respect to adoption of the interest deduction disallowance proposal.

The imposition of a tax on the rental value of property will be a discriminatory application against life insurance. We may buy a home, live in it for 20 years and then sell it. Our gain is measured by the sales proceeds in excess of cost basis. No adjustment is made to account for the rental value we derived for living in the home for those 20 years.

A convertible bond offers another example. If the bond is held to maturity or sold before maturity without exercise of the conversion privilege, an annual value will have been derived through the availability of that conversion privilege. However, that value will not be imputed and added to determine the gain. The adoption of this proposal will discourage the purchase of life insurance at all dollar amount levels.

AALU is much appreciative of the opportunity of presenting its views to the subcommittee. We would be pleased to provide such further assistance as may be requested.

Thank you.

Chairman STARK. Thank you very much, Mr. Schiff.

[The prepared statement follows:]

STATEMENT OF ALBERT J. SCHIFF, CLU, ASSOCIATE VICE PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

My name is Albert Schiff and I am a life insurance agent in Connecticut affiliated with Mutual Life of New York. I appear before you as Associate Vice President of the Association for Advanced Life Underwriting (AALU). Fred Kissling, President of AALU, testified at your May 10th hearings. He has asked me to express our thanks for your invitation to testify and to present our views today. I am accompanied by Gerald H. Sherman of the Washington, D.C. law firm of Silverstein and Mullens.

Our 1,100 members are vitally concerned with the ways in which the American life insurance policyholder is subjected to tax. We are dedicated to the proposition that current forms of level premium, permanent life insurance performs a socially vital function and that the availability of those forms must be preserved. We are not expert on the tax structure of life insurance companies and, as Mr. Kissling has previously stated, we do not presume to offer guidance in that area. Our focus will be on certain portions of the July 14th Committee Print section captioned, "Individual Taxation". We therefore place before you our conviction that the proposals in the Individual Taxation section, respecting policyholder loans and adjustments in policy tax basis, will, if adopted as proposed, have catastrophic effects for most permanent forms of life insurance protection.

If the deductibility of interest on policy loans is not available with a considerably greater freedom than that proposed, there will be a marked reduction in the sales of permanent life insurance and a marked increase in lapses of existing coverage. If the tax basis of life insurance policies is reduced by some measure of the periodic term protection, similar results will occur. If the interest deduction and basis adjustment proposals are enacted in tandem, the policy issuance decrease and lapse increase results will be that much more intense.

Given the specific examination of life insurance that this subcommittee has already undertaken, it should not be necessary to review here in detail the function of permanent, level premium cash value life insurance: without such forms of permanent protection, the cost of insurance at advanced ages would be very high and would act to discourage coverage at those ages—a time in life when insurance is obviously most necessary; in addition, the capital formation, which is made possible by the large cash value accumulations that are mathematically necessary to underpin the entire level premium system, will be substantially depleted; further, the livelihoods of substantial numbers of life insurance agents will be impaired.

In short, the proposals will disrupt the adequacy for each policyholder of our insured death benefit system, will decrease capital formation at precisely the time when such formation is sorely needed for the economy generally, and will arbitrarily and negatively affect the livelihoods of many life insurance agents in the United States. All this for no meaningful gain in federal revenues—more likely a reduction in federal revenues—and, as we will demonstrate, with little in the way of satisfactory technical and conceptual basis.

A. INTEREST DEDUCTION

Interest on policy loans has been deductible for many years. It was approximately twenty years ago that the last substantive adjustment of the deductibility of such interest was made in section 264 of the Revenue Code.[1] Why the need now for such a radical change as the total disallowance (subject to *de minimus* exceptions) of deductibility?

1. Relationship of Interest Deduction to Proposed Life Insurance Definition.—At the May 10th hearings it was suggested that something should be done about cash heavy investment contracts masquerading as life insurance. The recommendations in the Committee Print with respect to the definition of life insurance, if adopted, would eliminate the source of this concern. Under that definition there is no opportunity to "cash load" a life insurance policy. A large portion of the face value of the contract must at all times relate to pure death protection. Therefore any interest, which is deductible with respect to loans under such a contract, could not reasonably be said to apply to a non-life insurance product.

2. Financed Life Insurance Interest Cannot Exceed Externally Determined Market Rates and Cannot Be Manipulated.—It has been suggested that life insurance policy loans may be abused by utilizing interest rates well in excess of market rates, thereby creating a deductible charge which can be credited back in major part to the borrower through a tax-free cash value accumulation. This is simply incorrect. In some 35 to 40 states, interest on policy loans cannot exceed market rates measured by reference to the Moody's twenty-year bond rates.

For many years policy loans were available at rates which averaged between five and six percent and thus were historically within a generally understood band of market rates. As we entered the 1970's interest rates sharply inclined and the mandatory availability of five percent policy interest loan rates put life insurance companies in a vicious intermediation bind. In order to extract themselves permanently from that bind, companies sought and obtained from most states the ability to issue policies at so-called variable interest rates, i.e., interest rates pegged to the Moody's standard. This discouraged loan rate shopping and the disintermediation consequences, without pricing life insurance loans out of the market. If life insurance loans had been rendered too dear and life insurance policy cash values could no longer be reached by market rate loans, life insurance would simply have become a non-competitive product.

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[1] Public Law 88-272, § 215(a) (1963).

As a consequence of this movement over the past few years, life insurance loan interest rates can never exceed externally mandated market standards. Thus, there is no potential for abusive manipulation of those rates. In effect the level of relationship between the life insurance loan rate and the rates being used to credit additions to cash values are responsive to market factors—factors which are beyond the control of individual insuring companies. Although absolute interest rates may change from year to year, the rates used with respect to life insurance loans reflect no more than adjustments to the relative yearly values of money. The system is a variation of price indexing designed to maintain an inflation adjusted, flat, unchanging interest rate. It is not a system which is subject to manipulation; it is a system which cannot be manipulated.

Any arbitrary limitation, such as the interest deduction proposal before these hearings, would disrupt the disintermediation fix which over a number of years the industry has painstakingly developed, at the cost of great internal industry debate and totally without tax motivation. We urge the committee to exercise great care before it upsets this delicate balance.

3. Discriminatory Effect of Interest Deduction Disallowances.—The interest deduction proposal, instead of adjusting a tax inequity, in fact would practice a substantial discrimination of life insurance loans. No other property which develops long-term equities faces this kind of limitation.

We have noted the kind of deductible interest/tax free income relationship which the life insurance loan is said to generate. To begin with, to describe the income as being totally tax-free is inaccurate. Substantial taxes are raised at the life insurance company level, taxes which indeed will presumably become larger at the conclusion of this legislative exercise. Whether those taxes are collected at the company level or the policyholder level is, in terms of the dollar imposition on policyholders, not particularly relevant.[2] In fact, a tax burden is extracted, directly or indirectly, from the policyholder. The interest deduction is thus not arbitraged against tax-free income, such as occurs where, for example, loans are secured by such tax-free income generating instruments as state and municipal bonds.

A better analogy [3] is the borrowing by corporations against the security of their dividend-bearing stocks where 85 percent of the dividend income will be received tax free.[4] No interest deduction limitations are imposed under those circumstances.

In terms of this particular issue, life insurance presents a kind of hybrid circumstance. The deductible interest can be juxtaposed against the interest-like accumulation on cash values (which, as we have seen, is at least partially subject to tax) and the tax-free accumulation element at death. The tax-free nature of that accumulation is little different from the capital appreciation on any asset held to death. Under our standard date of death basis rules, the basis of an asset in the hands of the decedent's estate is the market value of that asset on the date of death [5] and any unrealized income is permanently excused from taxation. We do not disallow the interest deduction on a residential mortgage, even though any unrealized income on the residence disappears at death. We should not do so on life insurance, another asset which is held to death and which is characterized by similar tax treatment of gain at death.[6]

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[2] Whether taxes are collected at the policyholder level or company level may indeed be pertinent with respect to policyholder perceptions and to the effect on the willingness of potential policyholders to acquire new policies. However, each dollar of tax imposed on the life insurance industry will ultimately affect the policyholder, whether the tax is imposed on him directly or reaches him indirectly after imposition at the company level.

[3] But one that is, itself, perhaps to a lesser degree, too harsh to life insurance loans.

[4] § 243(a)(1) IRC 1954.

[5] § 1014 IRC 1954.

[6] Since corporations do not die, policies held by corporations are not directly subject to this date of death-basis analysis. However, a corporation's right to obtain tax-free income tax treatment with respect to policy proceeds at the death of the insured is encumbered with the offsetting burden that the corporation relinquish the deduction for premiums paid on the policy. The

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Even if one takes the view that the hybrid nature of a life insurance policy pushes the interest deductibility rule more towards some limitation than does the circumstance of a real estate mortgage, there is no need for amendment of the existing structure; section 264 currently imposes those limitations. Certainly there is no four out of seven rule applied to any loan other than a life insurance loan.

We ask you not to discriminate further against life insurance.

4. The Interest Deduction Disallowance Proposal Will Have the Effect of Reducing Both Death Benefit Coverage and Capital Formation.—Limiting the interest deduction disallowance to interest incurred on loans of more than $50,000 has a surface, but misleading, appeal as a means of permitting deductions in "deserving" cases without affecting the industry generally.

If one could be certain that his lifetime acquisition of level premium cash value insurance would involve policies encompassing no more than $50,000 in cash value, the proposal might have little effect in discouraging new sales of insurance. However, given standard inflationary expectations, little if any reliance can be placed on the $50,000 figure by taxpayers in even relatively moderate economic circumstances. The expectation that cash value accumulations will outpace $50,000 is real.

More to the point, any such limit, even if a larger amount, would discourage acquisition of cash value insurance and, conversely, encourage lapses of existing insurance. As we have said, it is not possible to structure a level premium lifetime policy without the payment, early in the years of the policy, of amounts greater than those necessary to generate current insurance protection. Desirable as that aim of lifetime insurance protection is, most of us would not place beyond our reach substantial dollar amounts for a benefit we will never see during our lifetimes.

In recent years more than 40 percent of all life insurance sales have consisted of policies of $100,000 or more in face amount.[7] In 1981, over $231,000,000,000 of $100,000 or greater face amount life insurance policies were sold. Assuming one-half of those policies consisted of term insurance and one-half of cash value insurance and assuming further that only 25 percent of the cash value insurance would never be purchased if the interest deduction were not available, sales of cash value life insurance would have been reduced by $40,000,000,000.

It may indeed be that this lost coverage will be replaced in part by term insurance. This, however, can occur only at the cost of two devastating social consequences. First, the policyholder will be unprotected in later years when it becomes virtually impossible to maintain the cost of term protection. Second, the term policies will generate no capital accumulation. The greater capital formation function of the life insurance industry is filled only through the availability of cash value products, primarily whole life policies. In effect, the committee print's proposal with respect to the interest deduction constitutes a tax on savings at precisely the time when such taxes should be discouraged and capital formation should be encouraged.

B. BASIS ADJUSTMENT

AALU opposes the recommendation that the term portion of cash value life insurance policy premiums be subtracted from the total premiums to arrive at the net basis for purposes of measuring gain on surrender. Not only does the proposal have conceptual problems, but, if implemented, will result in similar negative economic

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premium payment is an expenditure which would otherwise qualify for deduction as a normal trade or business expense. Consequently, any disallowance of the corporate interest deduction in recognition of the income tax-free nature of the insurance proceeds at death will be duplicative (and, thus, excessive) in that the deduction disallowance is currently extracted at the premium payment level.

[7] See the following table:

SALES OF $100,000 PLUS FACE AMOUNT POLICIES

Year	Total life insurance sales (in thousands)	Amount of sales	Percent of total sales
1981	$481,895	$231,310	48
1980	385,575	154,230	40
1979	329,571	108,760	33
1978	283,067	82,090	29

Source: LIMRA, The Buyer Study.

consequences to those we have noted with respect to adoption of the interest deduction disallowance proposal.

1. Discriminatory Tax on Rental Value of Property.—In conceptual terms, the adjustment for the term portion of the premium will not have an analogy in any other section of the Revenue Code and will constitute the imposition of a tax on the rental value of property. In this sense, it becomes a stark discriminatory application against life insurance.

We may buy a home, live in it for twenty years and then sell it. Our gain is measured by the sales proceeds in excess of cost basis. No adjustment is made to cost basis to account for the rental value as derived from living in the home for those twenty years. Why should we adjust for the term insurance value of a life insurance property?

A convertible bond offers another example. If the bond is held to maturity or sold before maturity without exercise of the conversion privilege, an annual value will have been derived through the availability, during each year in which the bond was owned, of the right to exercise the conversion privilege. At the time of disposition of the bond, whether at maturity or earlier, gain is measured by the excess of sales proceeds over the cost of the bond, including the portion of the cost which is assignable to the conversion privilege.

2. Life Insurance Sales Will Be Discouraged By High Potential Gain on Surrender.—The potential increase in taxable gain as a result of this proposal will tend to discourage the sales of cash life insurance at all dollar amount levels.

Assuming that standard rates, comparable to those recently proposed by the Treasury Department for group term life insurance, are utilized to measure the term values in question, a $100,000 life insurance policy acquired at age 45 will generate approximately $20,000 in term premium values by age 65. We briefly integrated that figure with the premium and cash value figures for a standard par policy and a standard non-par policy. After twenty years the total premiums on the non-par policy are approximately equal to the cash value of the policy, $34,000. If the policy were then surrendered, the gain would be $20,000, or approximately 60 percent of total cash value. The par policy had, after twenty years, a $38,000 cash value and, without the term premium adjustment, a taxable gain on surrender of $22,000. Adding to that gain the $20,000 term premium factor provides a taxable gain of $42,000, or 110 percent of the cash value. We cannot expect people to purchase into such devastating potential consequences which are likely to occur at a time when they are least affordable.

Policies tend to be surrendered only after policy loan potential has been exhausted and the insured has no viable economic alternative. In effect, the surrender of the policy, as compounded by the proposed increase in taxable gain, will become a financial catastrophe. If, as we have suggested, the policyholder has exhausted the policy loan potential at the time of surrender, he will have little, if any, cash proceeds from the transaction to apply to the tax burden.

3. Diminution of Capital Formation.—The point we previously made with respect to the interest deduction and capital formation applies to the basis adjustment suggestion with perhaps even greater effect. This adjustment is, pure and simple, a tax on capital. It will tend to discourage the acquisition of cash value policies and diminish the capital formation function of life insurance. When the interaction of the interest deduction and basis adjustment suggestions are taken into account, we can envision massive reductions in sales of cash value life insurance, comparable reductions in capital formation and as a consequence, major dislocations in the life insurance industry.

C. REVENUE LOSS POTENTIAL

Although the committee print suggested the amount of an overall revenue gain from the total of all of the proposals, it did not offer an item-by-item revenue consequence analysis. We would judge, without being certain, that there is minimal, if any, estimated revenue gain from the interest deduction and basis adjustment items. More likely, if we taken into account the reduction in cash value life insurance sales that are certain to occur in the event of the implementation of those suggestions, we can predict a reduction in federal revenues with respect to these items. In a time of federal budgetary crisis, this seem ill advised.

D. SECTION 79 (d)

We have not had an opportunity to examine with care the proposals with respect to the section 79 nondiscriminatory test as applied to group term life insurance. We, therefore, seek the Committee's permission to submit supplemental testimony on this subject at a future time. We would note, however, that, unlike the other recommendations contained in the committee print, the section 79(d) proposal applies only to employers and not to insureds. We would suggest, therefore, that this matter be severed from the main inquiry of the committee and be associated with more general tax legislative proposals.

AALU is much appreciative of the opportunity of presenting its views to the Subcommittee. We would be pleased to provide such further assistance as may be requested. Thank you.

Chairman STARK. I wanted to respond quickly and as best as I am able. I think this is correct. If I misspeak, the staff will pinch me.

In Mr. Press' written testimony, there was a question dealing with the provision in section 79 for group term life and the question of discrimination. Basically where the problem has arisen that certain life insurance has been given as a retirement benefit on a selective basis, mostly to highly paid executives.

We were saying to qualify that has got to be available with the same antidiscrimination basis that we provide any other basis for retirement. That is what we were getting at in that provision.

I might parenthetically suggest that there are a couple of little things in this proposal which were not part of the overall structure in restructuring life insurance. There are few perceived abuses that I think were tossed in as something to clean up some of the other problems.

Further, Mr. Schiff, or Mr. Press, I wanted to ask you, on your lowest available term rate in your illustration, was that an annual term or do you know what rate you picked?

Mr. PRESS. It was an annual renewable term insurance rate.

Chairman STARK. It if was nonrenewable, if it was just an annual rate and then aggregated——

Mr. PRESS. I did aggregate all annual costs.

Chairman STARK. Renewable has a higher cost than a nonrenewable, am I correct?

Mr. PRESS. Yes, sir.

Chairman STARK. So, if you took an annual renewable, you would have more aggregate premiums than if you merely took the 1-year renewable term rate for that same 30-year period and added it up, is that not correct?

Mr. PRESS. Yes, it is correct, sir.

Chairman STARK. So, if we did that, the figure would be somewhat lower than your $50. Is that correct, sir?

Mr. PRESS. Yes.

Chairman STARK. Now, if we eliminated from that annual renewable term rate the loading factor and I presume there is not a whole lot of interest cost in there, because it comes as close to a pure mortality cost, we would get it down even further, would we not?

Mr. PRESS. Yes, we would.

Chairman STARK. I think that is what we had in mind. In other words, to say, and in this illustration, you are not getting a lot of money, but I think you could quickly see it is the reverse side of the investment abuse, as we talked about in the policy that somebody could load in a big wad of cash value using the cash-free interest to buy themselves some insurance.

We felt that is potentially abusive. We may have even reacted as we indicated to you all earlier at the point of negotiation. On the other areas, I think we appreciate your calling to our attention the problems created, and we have a feeling that we can resolve these. We have no intention, particularly on the limitations on borrowing to impact on the marketing of what we have referred to as traditional whole life product, and I think that is a term which you all accept.

We have discussed some of the exaggerated types of numbers that lead to a perceived loss of revenue, and I think we will be able to work together to straighten that out. I want to thank the entire underwriting group, both associations represented here, for your cooperation and forebearance.

You have been helpful to us often. Whether it is not a 100-percent endorsement by certainly allowing us to wade through this and accepting our statement that we would consult with you if there were any problems that you perceived for your agency, of course, I would thank you very much.

Mr. Moore?

Mr. Moore. Mr. Chairman, I want to thank both of these gentlemen for testifying. Certainly we have great respect for the agents, and their values. We are not trying to hurt the average homeowner or average policyowner or the average person.

I borrow money against my life insurance policy. I wouldn't come under this $50,000. I would be very interested if you could get the figures for us of how many policyholders we are hitting with this level? We don't want to hit the average guy.

Let me show you the type of situation we are thinking of. This is an example of a person who buys a $1 million initial permanent life insurance at age 50. It has been worked out for us that he would wind up paying the premium for 30 years on that of $2,479,000. He would pay interest of $6.8 million for a gross outlay of $9.2 million.

Then he is able to write off the interest on that, $3.4 million. He is actually able to take out $7.3 million in loans, so he winds up coming out ahead $1.4 million. He has used this as a tax arbitrage scheme, not as an insurance plan.

That is not your average policyholder. We are talking about very few people here. These people aren't interested in insurance. This is an arbitrage plan of some kind. We chose the idea of limiting the interest deduction which makes this scheme not so rich.

But you can't have it twice. You can't have a tax-free inside buildup and then have tax-deductible interest on the loan to borrow that tax-free inside buildup. That is giving you a double whack at the Tax Code.

I noticed—Mr. Press, you are nodding your head like you are not trying to condone this kind of tax arbitrage. I think the average insurance agent doesn't even see this kind of thing, and certainly isn't trying to condone it. What we need from you is a breakout of what is the average type loan on a policy so we can see who we are hitting.

Maybe $50,000 is too low. Maybe it ought to be higher. Second, what is your suggestion to limit the tax arbitrage scheme that is going on? We are not here to do any of the things that you testified would be bad. That is not our goal.

Our goal is to get at this scheme which is making really a mockery out of life insurance. Because of the tax law, it becomes a way to beat the tax law.

Mr. SCHIFF. Mr. Moore, could I make a few comments on that?

As to the example that you give, while not being able to analyze what is behind it, there are a few things I would take exemption to. One, the idea of comparing the tax-free buildup from the shareholder's standpoint. I disagree that it is a tax-free buildup. Tax is paid at the company level and that is where it should be paid, and that is the other issue you are addressing.

I don't know the specific example and maybe some of the abuses in specific examples creating the tax leverage will be taken care of by the definition. Primarily, the definition now, as you proposed it, is going to build in enough additional insurance so that the term costs on the amount of pure protection will be such that nobody will want to buy life insurance purely for the arbitrage basis.

It won't make sense. It will not be a good tax shelter. The other areas that I would point out is the $1.5 million that I think is over a 30-year period. I am not sure of the cash flow that you are suggesting, but I wonder if in that $1.5 million you have taken into effect some factor for the use of money?

The $1 million policy, which has an annual premium outflow of approximately $100,000, probably does not compare very favorably to a tax shelter or other type of investment compounded at a reasonable rate of return over that period of time.

So, I would just question the fact whether it really is the arbitrage you think it is.

Mr. MOORE. First, it takes into account the cost of the premium, and the second point is that according to our tax counsel, the definition will prevent this from happening. And third, you are allowing a tax-free inside buildup, which is not like a savings account or not like buying stock or not like buying bonds.

Those are not tax-free buildups.

Mr. SCHIFF. That assumes that there was never a tax at the company level, which was then therefore passed down at the accumulation of the cash value to the policyholder. My contention is whether the company pays it or the policyholder pays it direct; it impacts the policyholder's value.

Mr. MOORE. When you put money into life insurance and borrowing it all out, you have to question whether it is an investment plan.

Mr. SCHIFF. Mr. Moore, you can't do that under the current rules.

Mr. MOORE. After a certain delay, you can. You can end up borrowing on a $1 million policy, about $7.3 million. That is pretty close to 100 percent.

Mr. SCHIFF. I can't respond to your example, but we would like to be able to take a look at that.

Mr. MOORE. That is what we are trying to address, not the concerns that you addressed in your testimony.

Mr. PRESS. Mr. Moore, may I respond? We are somewhat familiar with the example, having examined it. Before we could comment fully we would like to see a number of pieces of information that are missing, such as the death benefit in each policy year, and the guaranteed cash value in each policy year.

But in my opinion, this is purely an abusive type of contract, and our organization does not endorse the sale of such contracts.

We believe, however, that the cure for contracts such as this one lies in a definitional approach and not in an overall limitation on policyholder loan interest deductibility.

If you took a definitional approach to this contract, this contract falls outside the range of most of the traditional products that we sell. This product bears an initial level premium of $82 per $1,000 at age 50.

And in fact, it funds what is called an increasing face amount type of policy that is normally designed to create this arbitrage effect. We believe that you could cure this problem with a definitional approach, and need not attack the entire range of products that we sell.

Mr. MOORE. We don't want to kill the fly with a club, so you may well be right.

Mr. Chairman, what I would like to do at this point is ask permission to have this exhibit B-1 inserted in the record at this point and we will have staff make this available to you on your way out today.

Chairman STARK. Without objection.

[The information follows:]

EXHIBIT 1.—ILLUSTRATION OF $1,000,000 INITIAL PERMANENT LIFE INSURANCE ON EXECUTIVE NOW AGE 50: MAXIMUM BORROWING UNDER IRC SECTION 264, DEVELOPMENT OF NET OUTLAY

Policy year	Annual loan	Net cash value	Total loan	Gross annual outlay (premium due plus 10 percent loan interest)	Net outlay/gain (gross outlay minus annual loan minus tax savings)
1	0	$38,637	0	$82,644	$82,644
2	$82,644	27,379	$82,644	82,644	0
3	82,644	23,095	165,288	90,908	4,132
4	82,644	26,120	247,932	99,173	8,265
5	0	125,483	247,932	107,437	95,041
8	427,589	100	675,521	107,437	(332,548)
10	137,185	127	939,531	162,879	(14,423)
15	201,514	258	1,812,440	243,737	(38,323)
20	289,654	433	3,072,355	360,914	(67,875)
25	406,024	723	4,859,073	527,949	(100,727)
30	558,747	1,063	7,328,273	759,596	(137,627)
Total	7,328,273			9,283,952	(1,446,637)

30-year cumulative summary

Premium for 30 years	**$2,479,320**
Total loan interest	**6,804,632**
Gross outlay	**9,283,952**
Tax savings on interest deductions	**(3,402,316)**
Loans received	**(7,328,273)**
Net gain	**(1,446,637)**

Mr. **Moore**. Hopefully, you can get back with staff and give us your ideas on how we can address what I think is an arbitrage scheme and not an insurance policy.

Mr. **Press**. Yes, sir. We would certainly look forward to working with the committee on this problem.

Mr. **Moore**. Thank you, Mr. Chairman.

Chairman **Stark**. Mrs. Kennelly?

Mrs. **Kennelly**. Thank you, Mr. Press and Mr. Schiff. Just a quick question. It is my understanding that under the Stark-Moore proposal, the definition of life insurance would disallow the selling of ordinary, garden variety endowment policies as life insurance.

Am I accurate in this?

Mr. **Press**. Essentially, that is correct.

Mrs. **Kennelly**. Are there any other traditional policies that it would affect in this way?

Mr. **Press**. Well, there is a type of policy, called a retirement income endowment policy, which goes beyond the old type of endowment policy, which built up even more cash in the policy.

The policy was primarily used, although not always, in pension planning and that type of policy could no longer be sold.

Mrs. **Kennelly**. And the endowment policy?

Mr. **Press**. Yes.

Mrs. **Kennelly**. Is that a big part of your business?

Mr. **Press**. No, it is a very small part.

Mrs. **Kennelly**. Thank you very much.

Mr. **Schiff**. Technically, every life insurance policy is an endowment policy. It endows at some point in time. You have pointed out a policy which endows at age 95, but technically, every policy matures, and when it matures, it technically endows.

Mrs. **Kennelly**. That is correct.

Thank you.

Chairman **Stark**. I just wanted to make sure. We have discussed in your testimony, gentlemen, that you felt that we could correct some of these abuses in our definitions. As the definition of product now stands, do your organizations endorse our definition?

Mr. **Schiff**. The AALU in principle endorses it. We have not yet had an opportunity to examine what its impact would be on all the types of policies that our members are familiar with. We are doing that now.

Chairman **Stark**. Are you doing it with the 10-pay provision?

Mr. **Schiff**. In principle, we do endorse that. We do not have a problem.

Chairman **Stark**. Mr. Press?

Mr. **Press**. Mr. Stark, we cannot totally endorse the formula as proposed. We do believe that that sort of approach will correct some abuses, but would like to see how that formula will affect all of the different products we sell.

Chairman **Stark**. The companies, as you heard today, had a strong feeling about the 10-pay provision, and I think we indicated that if a rollover with the same premium payment into a different contract were allowed, that might solve some of that problem, but your comments on that would be very much appreciated as quickly as we can get them, because while the numbers will remain flexible, we would like to start putting together this structure in some more detail, and I know we can't analyze your products against the concept.

So, the more quickly we are able to get you some detailed language, I know it will be easier for you.

But any other changes or ideas that you have, as we move along, would be very helpful.

Again, I want to, for the record, thank Mr. Marriott for sitting through these hearings and I am sure that he will be able, in the weeks ahead, to add a lot to our deliberations.

I thank all of the witnesses and, again, the staff and members of the subcommittee for their work.

The committee will adjourn.

[Whereupon, at 5:30 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

AD HOC COMMITTEE
FOR A RESPONSIBLE TAX POLICY,
Washington, D.C., May 18, 1983.

Subject: There should be no changes in the taxation of annuities and annuity products.

Hon. FORTNEY H. STARK,
House of Representatives, Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN STARK: In the course of your Subcommittee's hearings on the subject of the taxation of insurance companies and insurance products, we believe that it is important to distinguish life insurance issues from issues dealing with annuity products.

I, therefore, would like to call to your attention some concerns about the taxation of annuities. Our principal concerns are as follows:

1. Tax deferred build-up during the accumulation period of deferred annuities should be preserved.
2. With respect to deferred annuity policies, the 100 percent deductibility of qualified guaranteed interest paid to policy holders should be continued.
3. Life insurance product issues should not be confused with issues relating to annuities and annuity products.

Our position on the above is justified for a number of very good reasons:

1. Unlike a life insurance contract which has a tax-free build-up and no taxes on death, annuities are ultimately taxed on death of annuitization.
2. The social desirability of not taxing social security, unemployment benefits, and mortgage interest deductibility is historically favored by our country and the fostering of retirement savings by individuals through annuities is in the same social and historical category.
3. If annuity inside build-up is not tax deferred, there will be no participants in annuity plans. This will eliminate a very important source of private retirement plans which are needed by middle income persons. If this source of private retirement plans is eliminated, it will put an additional strain on social security and other government-provided benefits.
4. Since over 90 percent of annuity premiums are invested in corporate and government bonds, a valuable funding source for industry and government will also be eliminated if inside build-up of annuities is not tax deferred.

THE TAX CHANGES MADE LAST YEAR WERE SATISFACTORY

The recent tax changes which were enacted called for LIFO treatment of taxing early withdrawals from deferred annuity policies and a 5 percent excise tax in return for 100 percent deductibility of all qualified guaranteed interest paid to policy holders by a company. The LIFO and excess tax provisions eliminated Treasury's concern that annuities were being used as short-term investment products. This having been done, no further basis exists for additional tinkering with the annuity product which is so important to a middle income family's retirement plans.

SOME COMMON MISPERCEPTIONS CONCERNING ANNUITIES

1. They are savings plans in disguise

This is not so. Each annuitant has a contractual right in his discretion to elect one of many options which require the company to pay over income to the annuitant for life. Since any annuitant can live for many years past normal life expectancy, the annuity company is taking a life risk. No other savings plan has this life-contingency risk. Accordingly, the special tax treatment is justified.

2. The modern annuity is a heavily investment-oriented product

This is not so. In the modern socio-economic environment, it is no different than the traditional annuities offered to buyers thirty years ago when 3¼ percent was the interest base of the product. From being heavily investment oriented, modern annuities have changed so that today annuity policy holders have not even kept ahead of inflation.

3. Important facts about annuities

(a) Annuities are bought by middle-class people averaging 56 years of age in average amounts of $20,000.00.

(b) Premiums are paid with dollars already taxed.

(c) Deferred taxes will be paid on death or annuitization.

(d) Annuities have a life contingency risk to the annuity company.

(e) Annuities are a valuable source of funds to capitalize industry and for government borrowing.

CONCLUSION

For the reasons discussed herein, we believe there should not be any change in the taxation of deferred annuities. We hope very much that you will be able to support this position, and urge your colleagues not to adversely affect, in any way, the existing taxation laws as they apply to deferred annuities.

We would like very much to meet with you to discuss these and other related issues.

Thank you very much for your interest.

Very truly yours,

DANIEL J. PILIERO II, *President.*

STATEMENT OF ACACIA MUTUAL LIFE INSURANCE CO.

This statement will be divided into several sections. First we will briefly comment on Acacia Mutual Life Insurance Company and its life insurance subsidiary, Acacia National Life Insurance Company. The second section voices our support of the mutual Company position except in one area. The third section will make general comments with respect to the proposal. The fourth section will explain how the proposal impacts upon Acacia with particular reference to the disallowance of the deductibility of policyholder dividends. Because of the results obtained under the proposal, as well as any reasonable variation of the proposal, we will explain that we have serious questions as to whether the specific approach will be workable. In the other sections, we comment with respect to several other specific provisions of the proposal which we believe need modification.

SECTION 1—ACACIA MUTUAL LIFE INSURANCE COMPANY

Acacia Mutual Life Insurance Company is the largest life insurance company domiciled in the District of Columbia. It has been in existence for 114 years and operates in a majority of the states and the District of Columbia. In 1974, we established a wholly owned stock life insurance subsidiary, Acacia National Life Insurance Company. This company was established in order to write annuities. However, in 1981, we developed a Universal Life product which has been issued by Acacia National.

As of June 30, 1983, Acacia Mutual's assets were $832 million and its life insurance in force was $4.4 billion. Acacia National's assets were $72 million and its life insurance in force was $1.4 billion.

SECTION 2—SUPPORT OF MUTUAL COMPANY POSITION

Except in connection with the definition of life insurance, my company strongly supports the positions which will be taken by the mutual company representatives at the hearing relative to the Subcommittee's proposal. We agree that the level of tax under the proposal would be too high. We feel that the ownership differential is much higher than it should be. We agree with the mutual company position that the approach used by the proposal of providing for a single phase tax based on economic income is sound and we strongly recommend that appropriate changes be made so that such approach will be workable if enacted into law.

We will explain Acacia's position concerning the definition of life insurance in Section 5.

SECTION 3—THE SUBCOMMITTEE PROPOSAL

Being located in Washington, DC, we have closely followed the deliberations and activities of the Subcommittee on Select Revenue Measures during the last four months. We have been very impressed with its careful and well organized approach to a very difficult and complicated tax law. We are also impressed with many of the items included in the proposal.

We feel that the effort to develop a single phase tax based on economic income, without the many special deductions and deferrals of the 1959 Act, is headed in the proper direction. We accept the elimination of the reserve adjustment under Section 818(c). We also can reluctantly accept the concept of an ownership differential, so long as the differential is appropriate in size and is reflected in a manner which relates to the deductibility of dividends.

SECTION 4—EFFECT OF PROPOSAL ON ACACIA

Having accepted the concepts of the proposal, we were shocked to see the details, especially as they relate to the equity base and the interest rate used in determining the return on equity. In applying these factors to Acacia, we were also very disturbed by the results. Based on our best estimates as to what our 1984 figures will be, Acacia Mutual will be entitled to deduct no dividends paid to policyholders. If our dividends to policyholders in 1984 are the same as we paid in 1982, they would be about $24 million.

Under Stopgap, we are allowed to deduct 77½ percent of our dividends. In 1982 our dividend deduction was therefore $18.6 million and the value of the deduction at 46 percent was $8.6 million. Our after-tax cost of paying the $24 million in dividends was $15.4 million. The complete loss of this deduction in 1984 would mean that, in order to keep our after-tax cost to $15.4 million, we would have to reduce dividends to policyholders to $15.4 million, a 35.6 percent reduction. Obviously we would not be able to make such a reduction and remain competitive with stock life insurance companies and other financial institutions.

Frankly, we do not feel that this result was intended. As we understand it, the idea of imputing a return on equity to policyholders of mutual life insurance companies was based on the premise that some portion of the dividends paid to policyholders is not a return of a portion of the premium but a return on the policyholder's ownership interest in the company. We understand the Subcommittee staff felt that the proposal would result in an average disallowance of dividend deductibility of about 24 percent. While we feel strongly that even a 24-percent differential would be too high, we cannot believe that the Subcommittee intended that, for any company, all of its dividends would be considered a return on equity.

To demonstrate the seriousness of the problem to Acacia, if the statutory surplus, without any additions, is used as the equity base, and our portfolio rate is used as the return on equity rate, about 26 percent of our policyholder dividends would be non-deductible. We feel that even this differential would be much too high, if a level playing field among stock and mutual companies is to be obtained.

Because of these results for Acacia, we are beginning to question whether the imputed return on equity approach is workable for many companies. While the objective of the approach and the need for an ownership differential can be understood, we believe that it would be far simpler and fairer to have the differential expressed as a flat percentage difference in the deductibility of dividends, such as 7½ percent. This would mean that if 100 percent of dividends, excess interest and phantom premiums is deductible by stock life insurance companies, 92½ percent of such items would be deductible by mutual companies.

We can understand why there has been some concern on the part of the Treasury Department and the Subcommittee that, under a flat percentage differential, some mutual companies could increase dividends to the point where they would pay no income tax. In order to avoid this possibility, which we frankly do not feel will occur very often, we would have no serious objection to a provision in the law which would state that the minimum amount of taxable income would be a small percentage, such as 7½ percent, of gains from operations before the deduction of dividends.

In connection with this last point, we feel that if stock companies are permitted to deduct 100 percent of dividends, excess interest and phantom premiums, they could also increase these deductions to the point where no income tax would be paid. Therefore, we feel that any minimum taxable income provision should also apply to stock companies.

SECTION 5—DEFINITION OF LIFE INSURANCE

The proposal states that the temporary guidelines dealing with the definition of life insurance for flexible premium life insurance contracts should be extended to all life insurance products, strengthened and made permanent. Our subsidiary, Acacia National, has been one of the leaders in developing a Universal Life insurance product. We feel that the provisions of TEFRA are basically sound and that they should be extended with as little change as possible. However, we realize that some changes must be made in order to make these provisions applicable to products other than flexible premium life insurance contracts.

We have two major objections to the proposed changes in the definition of life insurance. Under Alternative 1, the guideline single premium has been replaced by a premium based on a 10-pay life contract. This completely prevents any single premium contracts from qualifying as life insurance because the single premium would obviously be larger than the 10-pay life annual premium. We can understand why there has been some concern about possible abuses with respect to various types of single premium life insurance policies. It is true that under such a policy, a substantial lump sum is made and then the values, less charges accumulate at interest, tax free, without further premiums being paid. Under TEFRA a single premium or an amount less than a single premium but in excess of an annual premium may be paid. We do not feel that the basic problem is with the plan of insurance.

We feel that there is a legitimate need for single premium life insurance coverage. If there is a problem, which we doubt, the size of the single premium which is permissible could be changed from TEFRA, if necessary, by increasing the interest rate used in calculating it. This would result in a smaller single premium being permitted. However, it would not completely eliminate the use of single premium coverage. The corridor would also serve as another limitation on the amount of cash value which may be accumulated before the death benefit must increase to preserve the required risk element.

Our second objection to the new definition of life insurance is the size of the corridor under Alternative 1, subsection (b). Under TEFRA, the death benefit at age 40 or below must be at least 140 percent of the cash value. This scales down by 1 percent per year to 105 percent of the cash value. The proposal increases the percentage to 250 percent of the cash value at age 40 and below, scaling down by 4 percent per year to 110 percent. Although there may be a basis for a small increase in the TEFRA corridor, we feel that the proposed increase substantially exceeds any reasonable need which can be justified by the use of this policy.

In addition to the two above objections, we believe that it should be clear that by applying a corridor of this type to products other than flexible premium life insurance policies, the proposal would completely eliminate the use of regular endowment and retirement income endowment policies. We have a serious question as to whether this is a desirable result.

SECTION 6—RUN OFF UNDER 818(C)

The proposal states that companies would be required to revalue all reserves under the new rules for tax purposes as of January 1, 1984. Any difference between the tax reserves computed under the present law and the reserves computed under the new rules would be taken into account pro-rata over 10 years. In other words, the previous deferrals would be accelerated in many instances and treated as income over 10 years. We do not have a major objection in principle to this approach. However, we feel that it is based on the assumption that when the reserve adjustment was taken, it resulted in a full tax benefit to the company. In situations where this was true, there is certainly logic in having the deferral now treated as income over some period of time. However, because of the nature of the 1959 Act and the fact that many mutual companies were being taxed under Phase 1, the tax benefit received under this provision was limited to the increase in required interest because of the increase in the reserve. This tax benefit is substantially less than the tax benefit realized by a company which was being taxed under Phase 2 Negative.

Because many mutual companies have been taxed in such a manner in the past so as not to receive full tax benefit from the provisions of 818(c), we feel that any new law dealing with the run off should provide that the run off over the 10 year period would be included in taxable income only to the extent that a tax benefit was received in the past under 818(c).

SECTION 7—STOCK LIFE INSURANCE SUBSIDIARIES OF MUTUAL COMPANIES

The proposal states that where a stock life insurance subsidiary is 80 percent owned by a mutual life insurance company, it will be treated as a mutual company for tax purposes. We strongly object to this provision. To the best of our knowledge, it is unprecedented in tax policy. We feel that a stock subsidiary of a mutual company should be treated as any other investment of a mutual company and that a mutual company should anticipate a reasonable return on its investment in the stock subsidiary. Provided this is true, we do not believe that there is any rational basis for taxing a bona fide stock company as a mutual company. As a mutual company, we feel that we have an obligation to be very careful in how we invest the funds of our policyholders in the common stock of any corporation, including the stock of a subsidiary. We strongly recommend that this provision be eliminated and that the normal handling of the taxation of stock subsidiaries of a mutual company be continued as it has been in the past.

SECTION 8—LEVEL OF REVENUE

We understand that the American Council of Life Insurance will present detailed information with respect to the general level of taxation anticipated under the proposal. It is our understanding that the Subcommittee has started with the assumption that the tax paid by the life insurance industry under the 1959 Act for 1984, if no legislation is passed, would be $4.7 billion. It is estimated by the Subcommittee that the revenue provided under this proposal would be approximately $4.5 billion. We feel that this level of revenue is entirely too high and that it would have the result, if enacted into law, of making life insurance products even less competitive than they are at the present time with the products of other financial institutions. Further, we feel that the level of taxation contemplated by the proposal is substantially higher than the level of taxation paid by other corporations. Details with respect to these conclusions will be presented by the ACLI.

SECTION 9—SUMMARY

We commend the efforts of the Subcommittee in developing a permanent income tax for taxing life insurance companies. We like the basic simplicity of the proposal, with its single phase tax on economic income. However, we feel that the proposal generates an unfair level of taxation of the life insurance industry. We feel that the ownership differential is much too great and would result in mutual company products being non-competitive with the products of stock companies. We would prefer that any ownership differential be expressed as a flat difference in the deductibility of dividends, excess interest and phantom premiums, rather than as a minimum tax base. Finally, except in regard to the definition of life insurance, we fully support the mutual company positions.

ADVANCED UNDERWRITING CONSULTANTS,
Indianapolis, Ind., May 23, 1983.

Re Comments on life insurance taxation hearing.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN STARK: I sat through the two-day hearing on May 10th and 11th. I felt the various witnesses could have done a better job of informing you of what's selling best in the life insurance marketplace; hence, the purpose of this letter.

I operate Advanced Underwriting Consultants; we're hired by life insurance companies to provide tax and "advanced sales help" to their agents. While we've worked for three mutual life insurance companies in the past, our present clients are seven stock life insurance companies.

As part of our service to the companies I talk to about 400 life agents each month. What follows is my attempt to distill what these agents tell me they are selling in the advanced sales area.

THE SALES LEADERS

Several witnesses at the hearing mentioned that the newer and smaller stock companies have shown the greatest increases in life insurance sales in recent years. The increases are not due to "tax breaks" nor because their executives are measurably smarter than those of the older and larger stock companies and the mutuals. I feel they are due to two factors:

1. The smaller insurance company can introduce new and better insurance policies without disturbing its present business, that is causing the old policyholders to leave or exchange the older, more profitable (to the company) policies for the newer, less profitable policies. The smaller insurance company typically has little, old business to disturb.
2. The smaller insurance company is not burdened with selling through a captive agent force. It offers its products to all personal producing general agents and brokers it can reach.

THE MUTUALS

Perhaps, the lessening share of new insurance sales in mutual companies comes from the average agent who sells a $10,000, $25,000 or $50,000 whole life policy without mention of any "tax advantages". While the cash values of the insurance are mentioned at the time of sale, there's generally no plan put forth to systematically borrow these cash values.

The "big-hitters" in the mutuals' sales force typically sell "leveraged term", a whole life policy which is systematically borrowed against using the four-out-of-seven premiums exception found in Code section 264(c)(1). The illustration I've marked "1" is similar to what's sold. Notice that after the fifth policy year it's the deductible interest that pays for the insurance.

The run-up in interest rates in recent years caught all insurance companies short—to grant 5 percent loans many had to borrow short to lend long, rather than sell their bond investments at a discount.

Many states relented and now permit variable interest rates on policies. Taking advantage of this change a number of insurance companies are marketing a whole life policy with the interest rate tied to a Moody bond rate. In turn, the insurance company credits, for example, three-quarters of one percent less than the Moody rate to the borrowed funds.

Extreme leverage is possible. Question: are the purchasers buying life insurance or a way to substantially reduce their tax liability?

THE STOCKS

Many of the stock companies, and a few mutuals, have introduced universal life policies. To my knowledge no one illustrates the deductibility of interest on universal policy loans. The common opinion is the universal life policy is a series of single premium policies tied under one policy umbrella and, thus, does not qualify under the four-out-of-first-seven premiums exception mentioned previously.

The most common universal life illustration used in selling large size policies is to illustrate paying up the policy in eight to ten years. The illustration I've marked "2" is an example. It's felt "getting the policy paid up quickly" appeals to the older person who usually buys the larger size policy.

Universal life also is used to fund buy-sell agreements and deferred compensation plans. The illustration marked "3" is a typical deferred compensation illustration. The employer pays premiums on the policy for a period of years. At retirement age, the illustration shows the employer withdrawing sums from the policy to make the promised deferred compensation payments. Had the insured employee died prior to retirement the policy proceeds would have been used for this purpose. An arrow is usually placed on the illustration to show the year in which, under current law, further withdrawals are taxable. Funding buy-sell agreements can be illustrated in a similar manner.

RECOMMENDATIONS

My policyholder recommendations, based on the above, vary somewhat from those given by Mr. Chapoton at the hearing.

1. I feel as he does, restrictions should be placed on the interest deduction to purchase or carry life insurance. The present law is too similar to giving a person the right to deduct interest on loans to purchase municipal bonds.

Mr. Chapoton feels the participant loan provisions in Code section 72(p) should be applied to insurance policy loans. I feel these provisions are too cumbersome for an insurance company to police. "Is that loan in excess of $50,000 really being used to purchase or repair the insured's principal residence?" "Is the insured repaying the loan as per the repayment schedule?" "Has the insured really repaid his loan or merely rolled it over?"

As an alternative, I suggest the four-out-of-the-first-seven exception in Code section 26(c)(1) simply be dropped from the Code. The person who borrows from his life insurance to educate his children or for emergencies needs the money—the interest deduction usually is of little additional help to him.

I don't feel the elimination of Section 264(c)(1) will cause insureds to squeeze their loan interest deduction under the business purpose exception, Code section 264(c)(4). Existing case law prohibits a deduction of policy loan interest under Section 264(c)(4) for systematic plans to purchase insurance through borrowing.

2. I feel the income taxation of withdrawals from life insurance policies should either (a) be left as it is, or (b) taxed in a manner akin to the annuitization of the contract.

My reason for recommendation (a) is that in the universal life context, the agent and the insured first usually want to assure themselves that enough premiums have been paid to carry the contract without further premiums and despite the withdrawals. Thus, the withdrawals are typically illustrated to take place after ten years and after a substantial investment has been made in the contract. Despite withdrawals, considerable sums will be saved.

Contrast that to policy loans which are illustrated as early as the second policy year. Virtually nothing is left with the insurance company to invest after 264(c)(1) is satisfied.

If alternative (a) is not acceptable, it would appear easy for the insurance company to administer alternative (b). When the insured requests a withdrawal, the insurance company will determine the interest and premium elements in his policy as of that date and notify him of the portion of the withdrawal that is taxable. A 1099 form would accompany the withdrawal check.

I hope these comments and suggestions are helpful to you.

Sincerely,

MEL J. MASSEY, J.D., CLU.

PROVIDENT MUTUAL LIFE INSURANCE COMPANY

ZERO PAY PLAN

$100,000 LIFE FULL PAID AT 90 MALE AGE 40

FIRST ANNUAL PREMIUM $2,591.00

DIVIDENDS BUY PAID UP ADDITIONS

YR	NET PREMIUM	ANNUAL LOAN BEG YR	TOTAL LOAN BEG YR	INT AT 08.00%	ANNUAL OUTLAY	AFTER TAX OUTLAY	NET EQUITY END YR*	DEATH BENEFIT END YR*
1	2591	0	0	0	2591	2591	0	100000
2	2591	0	0	0	2591	2591	1368	102213
3	2591	0	0	0	2591	2591	3797	104662
4	2591	0	0	0	2591	2591	6377	107350
5	2591	2591	2591	0	0	0	6393	107511
6	2591	2591	5182	207	207	124	6592	107927
7	2591	2591	7773	415	415	249	7119	108529
8	2591	2958	10737	622	299	0	7318	108946
9	2591	3106	13843	859	388	0	7627	109413
10	2591	3255	17099	1107	[illegible]	0 10737	7957	109920
11	2591	3275	20378	1369	684	0	8501	110736
12	2591	3406	23780	1630	815	0	9056	111454
13	2591	3542	27322	1902	951	0	9663	112206
14	2591	3684	31006	2186	1093	0	10325	112987
15	2591	3831	34837	2480	1240	0	11151	113806
16	2591	3985	38822	2787	1393	0	11925	114618
17	2591	4143	42965	3106	1553	0	12840	115389
18	2591	4310	47275	3437	1719	0	13797	116125
19	2591	4482	51757	3782	1891	0	14895	116820
20	2591	4661	56418	4141	2070	0	15935	117470
21	2591	4848	61266	4513	2257	0	17028	118089
22	2591	5042	66308	4901	2451	0	18091	118706
23	2591	5243	71551	5305	2652	0	19330	119325
24	2591	5453	77004	5724	2862	0	20648	119947
25	2591	5671	82675	6160	3080	0	21951	120576
26	2591	5898	88573	6614	3307	0	23442	121216
27	2591	6134	94707	7086	3543	0	24903	121838
28	2591	6379	101097	7577	3788	0	26441	122456
29	2591	6634	107721	8087	4043	0	28063	123088
30	2591	6900	114621	8618	4309	0	29681	123756
31	2591	7176	121797	9170	4585	0	31346	124458
32	2591	7463	129260	9744	4872	0	33135	125078
33	2591	7761	137021	10341	5170	0	34768	125564
34	2591	8072	145093	10962	5481	0	36464	125867
35	2591	8395	153488	11607	5804	0	38000	125944
36	2591	8731	162219	12279	6140	0	39456	125772
37	2591	9050	171268	12977	6489	0	40876	125491
38	2591	9483	180751	13701	6852	0	42257	124932
39	2591	9821	190561	14459	7230	0	43496	124302
40	2591	10213	200775	15245	7622	0	44502	123553

ANNUAL PREMIUM INCLUDES PREFERRED RISK.

COLUMN ENTITLED "AFTER TAX OUTLAY" ASSUMES THAT THE POLICY LOAN INTEREST IS PAID DIRECTLY BY POLICYHOLDER EACH YEAR RATHER THAN BY POLICY LOAN, AND IT SHOULD BE NOTED THAT "ANNUAL LOAN" AMOUNT MAY NOT BE AVAILABLE UNTIL SUCH INTEREST IS PAID.

THE DIVIDEND RESULTS ILLUSTRATED ARE BASED ON THE CURRENT DIVIDEND SCALE WHICH REFLECTS AN 8 % POLICY LOAN RATE. THEY ARE NOT GUARANTEES OR ESTIMATES OF FUTURE DIVIDEND RESULTS WHICH WILL DEPEND ON FUTURE EXPERIENCE.

* REFLECTS USE OF YEAR END DIVIDEND AS ELECTED.

AMOUNTS SHOWN FOR NET EQUITY AND DEATH BENEFIT INCLUDE TAX SAVINGS RESULTING FROM LOAN INTEREST PAID THE FOLLOWING YEAR.

A VARIABLE TAX BRACKET IS ASSUMED: 30% FOR 5 YEARS; 40% FOR 5 YEARS; 50% FOR 30 YEARS.

SURRENDER SUMMARY	BEFORE TAX 20 YEARS	BEFORE TAX 40 YEARS	AFTER TAX 20 YEARS	AFTER TAX 40 YEARS
SUM OF PAYMENTS	25431	117967	10737	10737
EQUITY AT SURRENDER	15935	44682	15935	44682
DIFFERENCE	9496	73285	-5197	-33944
AVERAGE COST PER YEAR	475	1832	-260	-849
AVERAGE COST /YR /1000	4.30	15.70	-2.35	-7.27

AVERAGE DEATH BENEFIT FOR 40 YEARS IS $116,600

INTEREST ADJUSTED INDICES @ 5.00%	10 YEAR	20 YEAR
PAYMENT	17.78	16.67
COST	6.49	4.76

PAGE 1 TEXAS LIFE INSURANCE COMPANY 05-20-83

UNIVERSAL LIFE

FLEXIBLE PREMIUM ADJUSTABLE LIFE INSURANCE

CLASSIFICATION - STANDARD

MALE AGE 40 INITIAL STATED AMOUNT $100,000 NON-SMOKER

			CURRENT COST OF INSURANCE AND				GUARANTEED COST OF INSURANCE AND	
			CURRENT INTEREST OF 11.000%		ASSUMED INTEREST OF 9.000%		GUARANTEED INTEREST OF 4.500%	
			END OF YEAR		END OF YEAR		END OF YEAR	
AGE	YEAR	PLANNED PREMIUM OUTLAY FOR YEAR*	ACCUM VALUE	DEATH BENEFIT	ACCUM VALUE	DEATH BENEFIT	ACCUM VALUE	DEATH BENEFIT
40	1	1,524	796	100,000	793	100,000	718	100,000
41	2	1,524	2,096	100,000	2,072	100,000	1,872	100,000
42	3	1,524	3,515	100,000	3,441	100,000	3,049	100,000
43	4	1,524	5,064	100,000	4,907	100,000	4,249	100,000
44	5	1,524	6,756	100,000	6,476	100,000	5,471	100,000
45	6	1,524	8,606	100,000	8,160	100,000	6,713	100,000
46	7	1,524	10,635	100,000	9,969	100,000	7,974	100,000
47	8	1,524	12,861	100,000	11,914	100,000	9,249	100,000
48	9	1,524	15,307	100,000	14,007	100,000	10,536	100,000
49	10	1,524	17,993	100,000	16,256	100,000	11,832	100,000
50	11	0	19,338	100,000	17,096	100,000	11,615	100,000
51	12	0	20,794	100,000	17,970	100,000	11,314	100,000
52	13	0	22,375	100,000	18,862	100,000	10,920	100,000
53	14	0	24,095	100,000	19,833	100,000	10,418	100,000
54	15	0	25,971	100,000	20,827	100,000	9,795	100,000
55	16	0	28,019	100,000	21,862	100,000	9,034	100,000
56	17	0	30,251	100,000	22,935	100,000	8,115	100,000
57	18	0	32,692	100,000	24,045	100,000	7,013	100,000
58	19	0	35,367	100,000	25,196	100,000	5,704	100,000
59	20	0	38,307	100,000	26,390	100,000	4,156	100,000
61	22	0	45,137	100,000	28,921	100,000	196	100,000
64	25	0	58,425	100,000	33,048	100,000		
69	30	0	93,756	103,756	40,675	100,000		
74	35	0	154,642	170,106	49,063	100,000		
79	40	0	252,652	277,917	57,701	100,000		
84	45	0	406,529	447,182	66,617	100,000		
89	50	0	639,838	703,822	77,712	100,000		
94	55	0	985,873	1,084,460	103,223	113,545		

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05-20-83

TEXAS LIFE INSURANCE COMPANY
UNIVERSAL LIFE
FLEXIBLE PREMIUM ADJUSTABLE LIFE INSURANCE

MALE AGE 40 INITIAL STATED AMOUNT $175,000 CLASSIFICATION - STANDARD NON-SMOKER

			CURRENT COST OF INSURANCE AND				GUARANTEED COST OF INSURANCE AND	
			CURRENT INTEREST OF 11.000% —END OF YEAR—		ASSUMED INTEREST OF 9.000% —END OF YEAR—		GUARANTEED INTEREST OF 4.500% —END OF YEAR—	
AGE	YEAR	PLANNED PREMIUM OUTLAY FOR YEAR*	ACCUM VALUE	DEATH BENEFIT	ACCUM VALUE	DEATH BENEFIT	ACCUM VALUE	DEATH BENEFIT
40	1	3,500	2,551	175,000	2,515	175,000	2,314	175,000
41	2	3,500	5,883	175,000	5,751	175,000	5,209	175,000
42	3	3,500	9,543	175,000	9,240	175,000	8,191	175,000
43	4	3,500	13,565	175,000	13,003	175,000	11,260	175,000
44	5	3,500	17,989	175,000	17,062	175,000	14,417	175,000
45	6	3,500	22,861	175,000	21,446	175,000	17,663	175,000
46	7	3,500	28,236	175,000	26,189	175,000	20,998	175,000
47	8	3,500	34,174	175,000	31,326	175,000	24,422	175,000
48	9	3,500	40,737	175,000	36,891	175,000	27,933	175,000
49	10	3,500	47,994	175,000	42,921	175,000	31,533	175,000
50	11	3,500	56,029	175,000	49,461	175,000	35,220	175,000
51	12	3,500	64,941	175,000	56,568	175,000	38,995	175,000
52	13	3,500	74,843	175,000	64,304	175,000	42,860	175,000
53	14	3,500	85,862	175,000	72,737	175,000	46,817	175,000
54	15	0	94,437	175,000	78,305	175,000	47,371	175,000
55	16	0	103,985	175,000	84,361	175,000	47,813	175,000
56	17	0	114,629	175,000	90,951	175,000	48,122	175,000
57	18	0	126,518	175,000	98,135	175,000	48,277	175,000
58	19	0	139,824	175,000	105,984	175,000	48,251	175,000
59	20	0	154,747	175,000	114,578	175,000	48,015	175,000
60	21	0	171,457	188,603	124,015	175,000	47,535	175,000
61	22	0	189,972	208,969	134,392	175,000	46,772	175,000
62	23	0	210,468	231,515	145,833	175,000	45,681	175,000
63	24	0	233,151	256,466	158,479	175,000	44,210	175,000
64	25	-17,500	238,832	262,715	153,300	168,630	23,966	157,500
65	26	-17,500	245,087	269,596	147,650	162,415	2,333	140,000
66	27	-17,500	251,968	277,165	141,476	155,624		
67	28	-17,500	259,535	285,488	134,734	148,207		
68	29	-17,500	267,855	294,640	127,375	140,112		
69	30	-17,500	277,005	304,705	119,348	131,283		

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PAGE 1B                        TEXAS LIFE INSURANCE COMPANY                           05-20-83
                                       UNIVERSAL LIFE
                         FLEXIBLE PREMIUM ADJUSTABLE LIFE INSURANCE
                                                                 CLASSIFICATION - STANDARD
  MALE AGE 40            INITIAL STATED AMOUNT      $175,000    NON-SMOKER

                             CURRENT COST OF INSURANCE AND              GUARANTEED COST OF
                        ----------------------------------------           INSURANCE AND
       PLANNED     CURRENT INTEREST          ASSUMED INTEREST         GUARANTEED INTEREST
     Y PREMIUM       OF  11.000%                OF   9.000%             OF    4.500%
 A   E OUTLAY   -----END OF YEAR-----  -----END OF YEAR-----  -----END OF YEAR-----
 G   A   FOR        ACCUM       DEATH       ACCUM       DEATH       ACCUM       DEATH
 E   R  YEAR*       VALUE     BENEFIT       VALUE     BENEFIT       VALUE     BENEFIT
 -   - -------  ---------- ----------  ---------- ----------  ---------- ----------
70 31 -17,500     287,065    315,771     110,599    121,659
71 32 -17,500     298,111    327,922     101,050    111,155
72 33 -17,500     310,230    341,253      90,606    100,606
73 34 -17,500     323,517    355,869      79,183     89,183
74 35       0     357,440    393,184      85,794     95,794

75 36       0     394,761    434,237      92,957    102,957
76 37       0     435,787    479,366     100,719    110,791
77 38       0     480,847    528,932     109,101    120,011
78 39    ßßßßßßßßßßßßßßßßßßDDßßßJ
                                79 40          0    584,492    642,941     127,819  ■

80 41       0     643,839    708,223     138,230    152,053
81 42       0     708,741    779,615     149,392    164,331
82 43       0     779,601    857,561     161,336    177,470
83 44       0     856,869    942,556     174,100    191,510
84 45       0     940,983  1,035,081     187,714    206,485

85 46       0   1,032,410  1,135,651     202,210    222,431
86 47       0   1,131,660  1,244,826     217,624    239,386
87 48       0   1,239,180  1,363,098     233,975    257,372
88 49       0   1,355,508  1,491,059     251,296    276,426
89 50       0   1,481,520  1,629,672     269,676    296,644

90 51       0   1,618,137  1,779,951     289,205    318,125
91 52       0   1,766,069  1,942,676     309,924    340,916
92 53       0   1,926,031  2,118,634     331,872    365,059
93 54       0   2,098,273  2,308,100     355,004    390,504
94 55       0   2,283,248  2,511,573     379,306    417,237

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ADVANCED UNDERWRITING CONSULTANTS,
Indianapolis, Ind., July 25, 1983.

Re Statement on policyowner taxation, Stark-Moore proposals.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I operate Advanced Underwriting Consultants; we're hired by life insurance companies to provide tax and "advanced sales help" to themselves and their agents. While we've worked for three mutual life companies in the past, our present clients are seven stock life insurance companies.

Both the companies and myself are pleased with the policy owner (individual taxation) recommendations made by Congressmen Stark and Moore. They display a good understanding of the insurance marketplace, except, perhaps, for one area.

We recognize why you seek to place a specific annuity starting date on the nonqualified, "man-in-the-street" annuity. Far too many of these annuities have been purchased in recent years with no intent of ever annuitizing. In fact, purchasers have played with "contingent annuitant" designations in an attempt to save the next generation from annuitizing the contracts and realizing income.

On the other hand, many annuities are purchased by people who are in their sixties, who have their present income needs in hand, but who are uncertain as to whether they will have enough income if they live past their life expectancy. If the law forces these individuals to annuitize the purchased annuities at age 70½, they either will not buy or they will not be well served by the annuities they do buy.

Like you, we suggest there be a specific annuity starting date for the nonqualified annuity but that date be age 75. This still leaves a sufficient annuity payout period. Actuarial Table I in the Treasury Regulations states at that age the male life expectancy is 9.6 years and the female expectancy is 12.6 years.

Setting a date other than that for IRAs also reflects the fact the nonqualified deferred annuity is purhcased with after-tax dollars. We feel such purchaser should have an added measure of discretion as to the date he or she commences to take the income.

Sincerely,

MEL J. MASSEY, J.D., CLU.

STATEMENT OF HAROLD S. HOOK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN GENERAL CORP., HOUSTON, TEX.

1. PURPOSE

This memorandum comments on the impact on American General Corporation of the Life Insurance Income Tax proposal of July 14, 1983.

Estimated federal income taxes for our life insurance companies in 1984 are as follows:

	Million
Present law	19
Proposed law	43
Proposed law excluding 10 percent of reserve overhang	27
Proposed law excluding 10 percent of reserve overhang and changing TIA to 40 percent	22

Amounts held in the policyholders surplus account at the end of 1982 were $137 million.

2. TREATMENT OF RESERVES

We believe the appropriate reserve deduction for tax purposes should include all of the reserves required by state law. The reserve deduction in the proposal would be less than the appropriate amount for the following reasons:

(*a*) State laws limit the reserve interest assumption to that defined in the policy for purposes of determining guaranteed cash surrender values. For example, if guaranteed surrender values in the contract are based on 3.5 percent interest, the reserve assumption may not be greater than 3.5 percent. Over 60 percent of our new business cannot be valued at the maximum 4.5 percent interest rate under state law.

(*b*) State laws describe a minimum reserve calculation method (CRVM) which produces reserves greater than full preliminary term reserves for some contracts (depending on issue age, premium paying period, etc.).

(*c*) State laws generally do not permit a change in the reserve basis of a policy after it has been issued.

(*d*) State laws require reserves for "deficiencies," which are computed as the present value of any excess of net premiums used for reserve computations over gross premiums charged to the policyholder. The disallowance of a tax deduction for this reserve in the 1959 Act was based in part on the fact that the deficiency overlaps the difference between net premiums under the CRVM method and net premiums under the net level reserve method. If reserves are not allowed to be recomputed to net level under 818(c), Congress should consider allowing a deduction for increases in the deficiency reserves required by state law.

We believe that the 818(c) deduction has been a significant factor in the ability of our companies to compete with the much larger mutual companies for the past 20 years. Without such tax treatment the insurance industry might well have developed into an oligopoly. In addition, the total amount of savings accumulated in life insurance contracts might have been reduced, resulting in capital investment in the United States economy.

3. OWNERSHIP DIFFERENTIAL

We believe the proposed differential for mutual companies is appropriate. In principle, the differential should adjust for the personal tax incurred by shareholders on dividend distributions.

The pretax return on equity for our companies has averaged 20 percent for the past 5 years, based on statutory earnings and equity as defined in the proposal. In addition, we have been distributing over 60 percent of our after-tax earnings to shareholders. While we have some concern that the projected segment balance is more favorable to mutuals than that under the 1959 Act, we believe the proposed differential is fair to both sides and should result in a level playing field.

The treatment of stock life subsidiaries of mutual life companies as mutuals is essential to prevent a major erosion of tax revenues. Mutual life companies have no business purpose for selling interest-sensitive products through subsidiaries other than tax avoidance.

4. TAXABLE INCOME ADJUSTMENT

The proposed TIA at a 25 percent rate is not sufficient to offset the change in reserve methods and the loss of special deductions and deferrals. We believe an increase in the TIA to 40 percent or more is appropriate for the following reasons:

(*a*) Savings and loan institutions are allowed to deduct increases in bad debt reserves up to 40 percent of pretax income.

(*b*) Savings and loans and banks are allowed to hold very conservative amounts of bad debt reserves. Under the proposal the conservatism permitted in life insurance reserve deductions would be substantially eliminated.

(*c*) Savings and loans and banks are not required to prorate tax-exempt interest and dividend deductions. This treatment results in minimal tax revenues from both types of financial institutions. To maintain a level playing field between financial intermediaries it is necessary to provide life insurance companies with either (1) the reserve methods, special deductions, and deferrals in the 1959 Act, (2) a reduction in tax rates such as the TIA, or (3) the elimination of proration.

5. TAX-EXEMPT INCOME

The tax treatment of tax-exempt interest and dividends in the life insurance industry is punitive relative to other financial institutions. It has forced life insurance companies to avoid investments in tax exempt bonds almost entirely, and it has substantially reduced investments in common and preferred stocks.

Banking institutions have used such investments to substantially eliminate taxes for that industry. While TEFRA introduced a modest preference tax on income from tax-exempt bonds, these institutions have still no limit on deductions for intercorporate dividends.

6. DEFINITION OF LIFE INSURANCE

Approximately 40 percent of the sales of our companies represent flexible premium life insurance contracts (universal life). These contracts have all been revised or amended in the past twelve months to incorporate the corridor provisions and guideline premium requirements described in TEFRA.

The proposed rules would significantly restrict the flexibility of universal life contracts. Significant limits would be placed on the amount of premiums that could be paid at the time contracts are issued (typically transfer of cash values from existing contracts within our own company) and would force the policyowner to withdraw his cash.

When a policyholder wishes to apply additional premiums at older ages to prefund his contract, the proposal would force us to grant significant increases in death benefits which would require evidence of insurability. In many cases we would be forced to refuse the additional premium and additional coverage.

The proposal also prohibits us from offering traditional fixed premium contracts which provide increases in death benefits after issue. Our companies have been offering contracts with increasing death benefits throughout our history. Some typical death benefit patterns are:

(*a*) A level death benefit at juvenile ages, increasing perhaps five times at some age or ages between 15 and 25.

(*b*) A death benefit equal to a level amount plus, if death occurs before the end of a certain period, a return of annual premiums.

(*c*) A death benefit equal to a level amount plus, if death occurs before a certain date, a return of the cash value.

(*d*) In substandard mortality situations, a death benefit equal to a return of premiums plus interest for the first several policy years, and a level death benefit thereafter.

(*e*) A death benefit which increases at age 65 to coordinate with the anticipated decrease in group life coverage.

We believe increases of these types are reasonable in view of changing insurance needs. If the increases do not occur after the end of the premium paying period, such plans are not abusive and should not be denied traditional tax treatment.

7. ANNUITY RULES

We believe it is not appropriate to conform nonqualified annuity penalties with those for IRAs, since such contracts do not qualify for deductions as premiums are paid. The annuity changes made in TEFRA last year caused us to revise our contracts and develop costly administrative procedures, and have adversely affected our sales. These changes were "permanent" and should not be reconsidered so soon.

One oversight in the TEFRA changes was that the capital gains tax on variable annuities was not eliminated at the same time that fixed annuity contracts were given full deduction of guaranteed interest credits. We believe this is an unfair restriction on our marketing efforts which should be removed.

8. POLICYHOLDER LOANS

Of our $700 million of policy loans, probably less than 5 percent are held by taxpayers with over $50,000 of total loans on all of their policies. Our records indicate that the average policy loan is $5,000 per policy for those who are not known to have a plan of borrowing, and $10,000 for those that do. The average loan per household is probably double these amounts, since most households have two or more policies.

We know that we have a number of corporate policyowners who have loans substantially in excess of $50,000 on all policies owned. These contracts would lapse at a financial loss to us if the proposal were adopted.

We believe it is unfair for Congress to change the tax treatment of loans on policies now in force, which were purchased on the basis of a plan which complied with Section 264. We urge that any such restriction be applied only to contracts issued after the date of the Act.

9. COMPUTATION OF INVESTMENT IN THE CONTRACT

We believe this provision is contrary to public policy in that it would discourage people from maintaining life insurance at post-retirement ages. It would be expensive to administer, involving over 200,000 computations per year in our companies. We urge that this proposal be rejected.

10. PREVIOUSLY DEFERRED AMOUNTS AND REVALUATION OF RESERVES

We believe that a new act such as this should not impose taxes on the amounts now held in the policyholder surplus accounts or the reserve change produced by recomputation under the new method. The 1959 Act should be viewed as a transition between an investment income tax and a corporate income tax, and the deferral provisions were designed to ease that transition and maintain competitive balance. The record shows that they were not intended to produce significant taxes.

The reserves should begin with a fresh opening balance, as they did in 1959. For many companies and tax years the reserve increases did not result in a tax benefit since the tax was based in whole or in part on investment income.

STATEMENT OF THE BANKERS LIFE, DES MOINES, IOWA

The Bankers Life in Des Moines, Iowa, is a mutual life insurance company that started over a century ago, and for whom employer sponsored retirement plans are very important business. We manage between $7 and $8 billion of such pension plan assets for about 15,000 employer plan sponsors, most of these small and medium size employers. These assets are about 70 percent of our total company assets. We also write both individual and group life and health insurance policies.

The Stark/Moore proposal will hurt us badly in competing for pension plan business. Major competitors include other institutional investors, such as banks and mutual funds. Also, many employers "self-manage" their pension funds using outside investment counsel, or in some instances, in-house management. This competition is effective—insurance companies in the aggregate hold about 35-40 percent of private pension assets—the competition has the rest.

There is no federal income tax on investment income on qualified pension funds managed outside of insurance companies, whether self-managed or managed by banks or mutual funds. Before 1959, insurance companies were on an unlevel playing field as to federal income tax on pension funds. Pension funds managed by insurance companies did, prior to 1959, incur federal income tax through the operation of the income tax law on insurance companies. This was an important competitive disadvantage for insurers.

The 1959 law, by providing essentially equivalent tax treatment for insurance companies and non-insurance managers of pension funds, tended to level-up the playing field by special provision for pension assets managed by insurance companies.

Now the Stark/Moore proposal would reintroduce serious imbalance. We estimate for our company it would cut interest rates we credit on pension funds by ½ percent to ¾ percent. A competitive edge of this magnitude would be truly a severe disability for us and would be an important advantage for our competitors. For the employer who keeps his pension plans with us, it would raise costs or decrease employee pension benefits, depending upon the type of plan. These employers are not the Funtune 500. They are the small and medium size businesses of America which do not have as many options for managing their pension plans as do larger employers. A tax on life insurance companies that translates to a ½ percent to ¾ percent reduction in pension fund yields of the small and medium size businesses of America is a staggering figure.

How does the Stark/Moore proposal result in ½ percent to ¾ percent decrease in pension fund yields for funds we manage? This is the result of (1) restricting tax reserves to minimum reserves thereby increasing both tax gain from operations and equity base, and (2) the imputed rate of return on equity being clearly excessive. Much of the pension fund money placed with us is used to guarantee pensions payable for the life of the retiree. We must hold adequate reserves (including contingency reserves)—not minimum reserves—to make good on these guarantees to the retired people and their employer plan sponsors.

Competitors outside the life insurance industry are allowed to accumulate contingency reserves within the pension plan and shelter the investment income. We should be permitted to do likewise.

Why are contingency reserves needed? One reason is that people are living longer—in the technical phrase, mortality is improving at older ages. This is not new. Improvement has been going on for decades. This has been demonstrated statistically and is widely reported in actuarial literature.

Continued future improvement is likely, but the extent is not certain. Even partial cures for any of the major diseases such as heart disease or cancer, could make these contingency reserves inadequate.

The reserves held on these pension guarantees can and will vary from one insurer to another, depending on the mortality experience unfolding for the persons they are covering.

Use of a more appropriate rate of return on equity together with provision for contingency reserves on pension plans sufficient to maintain a level playing field for pension plans is a desirable objective. Development of appropriate guidelines on tax reserves for pension plans would be required. We stand ready to work with you in any way that can be helpful to you.

An income tax on insured pension funds unfairly destroys the concept of a level playing field. In your search for a reasonable income tax law for insurance companies, we ask you not to return us to the pre-1959 era by imposing an unfair federal income tax burden on insured pension funds.

STATEMENT OF LOUIS J. WILLIE, ON BEHALF OF BOOKER T. WASHINGTON LIFE INSURANCE CO., BIRMINGHAM, ALA.

Booker T. Washington Life Insurance Company appreciates the opportunity to submit this statement for inclusion in the record of the Subcommittee's Hearings on the Taxation of Life Insurance Companies and Their Products.

Booker T. Washington Life is a stock life insurance company organized under the laws of the State of Alabama, with its home office in Birmingham. Our company was founded in 1923 and, at the end of 1982, it had assets of approximately $25 million and life insurance in force of approximately $600 million. As these numbers indicate, Booker T. Washington Life is a small company. It is for this reason that we are quite interested in the work of this Subcommittee. We hope that this statement of our views will assist the Subcommittee in its efforts to assure that the tax treatment of life insurance companies will be fair and equitable for all companies, be they small or large, stock or mutual.

As an introductory matter, we wish to note that Booker T. Washington Life is a member of the National Insurance Association. The Association testified before this Subcommittee, and we endorse the Association's statement. In addition, our company agrees with the testimony delivered by the other two associations of small life insurers, the National Association of Life Companies and the Life Insurers Conference. As those groups testified, the Life Insurance Company Income Tax Act of 1959 has fairly taxed all segments of the life insurance industry for nearly 25 years. The 1959 Act has raised adequate and increasing levels of revenue while providing a "level playing field" for all life insurance companies, regardless of their form of organization. With certain modifications, the 1959 Act can continue to accomplish these necessary goals.

Most importantly from our perspective as a small company, the 1959 Act has allowed small companies to grow and compete with the giant mutuals that dominate the life insurance industry. Brooker T. Washington Life strongly believes that any substantial changes in the basic structure of the 1959 Act would make it impossible for small companies—especially small stock companies— to compete with the large mutual companies. In our opinion it is essential that the 1959 Act's limitation on the deduction of policyholder dividends be retained in the law. This limitation, which we view as the cornerstone of the 1959 Act, embodies a congressional recognition that dividends paid by mutual life insurance companies are in part a distribution of corporation earnings to the owners of a mutual company, the policyholders. Moreover, it provides that distributions of a mutual life insurance company's corporate earnings to its owners are treated at the corporate level in the same manner as the distributions to owners made by all other corporations, including stock life insurance companies. Without this limitation, mutual life insurance companies would be granted a significant competitive advantage by the Federal income tax law.

It has been proposed to this Subcommittee that the 1959 Act's $250,000 minimum deduction for policyholder dividends be increased to $1,000,000, as was done in the temporary law passed last year. It has also been proposed that the Act's small business deductions be increased to $100,000. In view of the inflation that has occurred since the enactment of the 1959 Act, both of these changes are warranted. Under these proposals, moreover, both of the increased figures would be subject to a phaseout, assuring that smaller companies would benefit from the increases. We endorse these proposals.

In addition, we wish to emphasize that the 1959 Act contains a number of other provisions that are particularly important to small companies such as ours. Prominent among these is the section 818(c) adjustment for preliminary term reserves. Other testimony has discussed the reasons why these provisions are important to small companies, and we will not repeat those reasons here. Suffice it to say that the repeal of section 818(c) would result in a severe discrimination against small companies.

There is one final point that we would like to make. A number of individuals who testified before this Subcommittee argued that the 1959 Act should be replaced because it is too "complicated." Indeed, the representative of one of the country's largest mutual life insurance companies stated that all of his company's Federal income tax returns since 1959 were still open, and he contended that this was attributable to the complexity of the 1959 Act. We would respectfully submit that Booker T. Washington Life fully understands the 1959 Act, including the operation and rationale of that Act's deductions and deferrals. We believe that a giant mutual company, with all of its resources, should also be able to understand the Act.

In conclusion, Booker T. Washington Life appreciates the opportunity to submit this statement to the Subcommittee, and we would be pleased to assist the Subcommittee in its important task in any way that it might desire.

AUSTIN, TEX., *April 26, 1983.*

Re Subcommittee on Select Revenue Measures Hearings on Taxation of Life Insurance.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: Please forward these written comments on the referenced matter to the members of the Subcommittee. I will not ask to appear before the Subcommittee.

I take no position on the particular issues to be discussed. I have only one observation: The management and investment activities of life insurance companies are usually closely regulated by the states. Thus, taxpayers' funds invested with life insurance companies (even those invested largely for tax reasons) tend to flow into sounder elements to the capital market and to be managed by more expert hands. This is not true of other types of tax-motivated investment, such as residential rental property.

If one assumes that a well-advised taxpayer will find tax shelters of some type, the Subcommittee ought to consider the extent to which any adjustment in the tax benefits to life insurance policyholders will "chase" investment capital into lower tiers of the capital market.

Given this consideration, the best course toward parity of life insurance with other higher-tier capital accumulators (certificates of deposit, etc.) may be to extend income deferral treatment to those other types of accumulators, while simultaneously restricting the tax advantages of lower-tier investments.

Yours truly,

C. JOSEPH CAIN.

STATEMENT OF ROBERT L. WEISE, VICE PRESIDENT AND GENERAL COUNSEL, CHARTER NATIONAL LIFE INSURANCE CO., ST. LOUIS, MO.

For the past ten years, stock company members of the insurance industry have endeavored to develop new products in order to combat disintermediation, but in so doing developed products which passed on to consumers increasing benefits resulting from the investment income of the assets generated by the sale of such products. Such products are commonly referred to as: "Universal Life", "Variable Life", "Single Premium Increasing Benefit Whole Life", "Variable Annuity", and "Single Premium Deferred Annuity." These products are extremely competitive, not only within the insurance industry, but within the financial industry as a whole.

The Treasury Department became increasingly sensitive to the tax aspects of such products. As a result, Congress passed Treasury sponsored language in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which provided for certain limitations in the definition of life insurance as it pertains to flexible premium or "Universal Life" products, and changed the method in which the owners of annuities are taxed. The legislation was not extended to all life insurance products.

This Sub-Committee has published suggestions for further limiting the definition of life insurance and extending such definition to all life products. The transitional or "effective date" language does not "grandfather" current contracts as to the effects of the proposed definition. "Grandfathering" should be implemented to protect companies which have designed products for the market based on the historic definition of life insurance in both state legislation and regulation and in court interpretation from *Le Gierse* through *Evans.* If such "grandfathering" is not implemented, the policies currently in existence which fall outside the proposed definition of life insurance will be surrendered for the greater of the cash surrender or other guaranteed termination value and a financial run will occur on those companies which have issued such policies. The results of such a run may cause havoc to the industry as a whole, and set an undesired precedent for future tax legislation.

We therefore recommend that the effective date of the proposed legislation be imposed *on contracts issued* after January 1, 1984.

One of the chief concerns of The Honorable John E. Chapoton in his testimony before this Sub-Committee was regarding the investment rather than risk protection aspects of Single Premium Life Insurance Policies. Since it was felt that TEFRA imposed new restrictions making the Single Premium Deferred Annuities more acceptable, the market position of such contracts was not discussed. No concern was given to the fact that companies within the industry are at an extreme competitive disadvantage in the sale of such products if they are domiciled in any of the 16 states which impose premium taxes on the sale of such products. Any company domiciled in these states must pay a retaliatory premium tax equal to the tax in their domiciliary state to any other state in which they sell annuities, except Hawaii and New Mexico, which are non-retaliatory. Companies domiciled in the following states pay the higher of the premium tax in their domiciliary state of that in the states in which they sell annuities, as follows: North Carolina 2.5 percent; California 2.33 percent; Iowa, Kansas, Kentucky, Maine, Mississippi, Missouri, Nebraska, Nevada, and Washington, D.C. 2 percent; Tennessee 1.5 percent; South Dakota 1.25 percent; and Alabama, West Virginia and Wyoming 1 percent. This situation was one of the basic reasons Charter National Life Insurance Company developed its Single Premium Increasing Benefit Life Policy. It is therefore recommended that in the event a definition of life insurance is written that disqualifies such Single Premium products as qualified life products under Section 101 of the Code, provisions will be made to give such products equal treatment to that given Single Premium Deferred Annuities.

Currently, the definition of life insurance imposed by TEFRA on flexible premium products uses a defined "corridor" of risk which is manufactured mathematically, and not in keeping with ordinary actuarial standards. We would recommend such a corridor be actuarially designed. As a definition of life insurance containing a life risk provision acceptable to the Treasury Department, we would recommend acceptance of either of the alternative single tests, using actuarially computed methods, as follows:

NET SINGLE PREMIUM TEST

The cash value at issue and at any policy anniversary may not exceed the net single premium for the future benefits guaranteed under the contract. This test is to be applied annually at each policy aniversary and based on the then guaranteed values.

Computation rules

1. The mortality table shall be 1980 CSO without selection factors.
2. The interest rate in each year shall be the greater of 4 percent or the rates guaranteed under the contract.
3. The net amount at risk (Current Death Benefit less Current Cash Value) in each future year shall be no greater than the amounts guaranteed under the contract, but in no event may the net at risk in future years be greater than the actual net at risk in the current year.
4. The endowment amount may be no greater than the amount guaranteed under the contract, but in no event may it be greater than the current year's total death benefit.
5. The endowment age guaranteed under the contract at policy issue may not be less than the lesser of issue age plus 20 years or age 95.

Attached is a table at 4 percent interest of net single premiums and ratios of death benefits to cash values by attained age for whole life policies showing minimum death benefits permissible under the formula.

ACTUARIAL DETERMINATION OF CORRIDOR TEST

1. Define the minimum socially acceptable ratio of Death Benefit to Cash Value at age 40.
2. Convert this ratio to a term cost per $1,000 of Beginning of Year Cash Value, based on an acceptable "q" (mortality) [1980 CSO].
3. Allocate same amount per thousand of Cash Value at each age over 40. Net Death Benefit is what same amount buys based on "q" table at same age.
4. No Premium Test is necessary.

AGE	NSP	RATIO
0)	198.36	504%
1)	202.09	495%
2)	207.94	481%
3)	214.00	467%
4)	220.22	454%
5)	226.61	441%
6)	233.19	429%
7)	239.95	417%
8)	246.91	405%
9)	254.06	394%
10)	261.37	383%
11)	268.85	372%
12)	276.46	362%
13)	284.19	352%
14)	292.00	342%
15)	299.89	333%
16)	307.85	325%
17)	315.87	317%
18)	323.96	309%
19)	332.15	301%
20)	340.45	294%
21)	348.89	287%
22)	357.46	280%
23)	366.17	273%
24)	375.04	267%
25)	384.06	260%
26)	393.22	254%
27)	402.52	248%
28)	411.95	243%
29)	421.49	237%
30)	431.14	232%
31)	440.88	227%
32)	450.70	222%
33)	460.60	217%
34)	470.56	213%
35)	480.57	208%
36)	490.62	204%
37)	500.70	200%
38)	510.80	196%
39)	520.91	192%
40)	531.01	188%
41)	541.11	185%
42)	551.18	181%
43)	561.23	178%
44)	571.24	175%
45)	581.21	172%
46)	591.13	169%
47)	600.99	166%
48)	610.80	164%
49)	620.54	161%
50)	[illegible]	[illegible]
51)	639.80	156%
52)	649.30	154%
53)	658.69	152%
54)	667.98	150%
55)	677.16	148%
56)	686.21	146%
57)	695.13	144%
58)	703.93	142%
59)	712.60	140%
60)	721.15	139%
61)	729.56	137%
62)	737.83	136%
63)	745.95	134%
64)	753.92	133%
65)	761.73	131%
66)	769.37	130%
67)	776.86	129%
68)	784.19	128%
69)	791.36	126%
70)	798.39	125%
71)	805.26	124%
72)	811.97	123%
73)	818.51	122%
74)	824.86	121%
75)	831.02	120%
76)	837.01	119%
77)	842.82	119%
78)	848.48	118%
79)	854.01	117%
80)	859.40	116%
81)	864.68	116%
82)	869.83	115%
83)	874.85	114%
84)	879.74	114%
85)	884.50	113%
86)	889.15	112%
87)	893.71	112%
88)	898.23	111%
89)	902.74	111%
90)	907.30	110%
91)	911.96	110%
92)	916.78	109%
93)	921.85	108%
94)	927.27	108%
95)	933.11	107%
96)	939.47	106%
97)	946.38	106%
98)	953.80	105%
99)	961.54	104%

AGE	RATIO AT BEGINNING OF YEAR
40	200.00
41	192.67
42	185.37
43	179.18
44	173.13
45	167.83
46	162.76
47	158.32
48	154.22
49	150.52
50	146.98
51	143.76
52	140.52
53	137.47
54	134.57
55	131.83
56	129.38
57	127.17
58	125.24
59	123.50
60	121.92
61	120.43
62	119.04
63	117.73
64	116.48
65	115.34
66	114.30
67	113.38
68	112.55
69	111.82
70	111.16
71	110.53
72	109.93
73	109.37
74	108.83
75	108.35
76	107.92
77	107.54
78	107.21
79	106.93
80	106.68
81	106.45
82	106.23
83	106.02
84	105.83
85	105.65
86	105.49
87	105.35
88	105.23
89	105.12
90	105.03
91	104.94
92	104.86
93	104.79
94	104.72
95	104.64
96	104.55
97	104.43
98	104.29
99	104.14
100	104.00

AGE	RATIO AT BEGINNING OF YEAR
40	250.00
41	238.85
42	227.75
43	218.33
44	209.14
45	201.08
46	193.37
47	186.62
48	180.37
49	174.76
50	169.37
51	164.47
52	159.55
53	154.91
54	150.49
55	146.32
56	142.61
57	139.24
58	136.30
59	133.65
60	131.25
61	128.99
62	126.88
63	124.88
64	122.99
65	121.24
66	119.66
67	118.26
68	117.01
69	115.90
70	114.88
71	113.93
72	113.03
73	112.16
74	111.35
75	110.61
76	109.96
77	109.38
78	108.89
79	108.46
80	108.08
81	107.72
82	107.39
83	107.08
84	106.78
85	106.50
86	106.26
87	106.05
88	105.87
89	105.71
90	105.56
91	105.43
92	105.32
93	105.20
94	105.09
95	104.97
96	104.83
97	104.65
98	104.44
99	104.21
100	104.00

COMMENTS ON
PROPOSED
LIFE INSURANCE COMPANY
TAX LEGISLATION
DATED JULY 14, 1983

Submitted by:

Edward M. Burgh
Vice President and Senior Tax Counsel

Combined Insurance Company of America
Northbrook, Illinois
(312) 564-8000

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I. Review of Specific Provisions of Proposal

We will first review the specific provisions of the Proposal.

Overview

The Committee believes that a life insurance company can be taxed equitably under the same tax rules applicable to corporations generally, with four additional special tax rules enacted to address the unique aspects of the life insurance industry. It is an admirable goal to try to bring the insurance industry into the general corporate taxing structure of the Internal Revenue Code. It would certainly be easier to interpret the tax rules since court precedents and existing IRS interpretations concerning the general corporate taxing scheme are already available. However, life insurance companies are not like other companies for many reasons and, as will be explained in the sections which follow, the four special rules proposed to address the unique aspects of the insurance industry do not fully anticipate the life insurance industry's special concerns.

The Proposal seems to be based on the underlying concept that special deductions, net level revaluation and the deferral of profits are no longer needed by the life insurance industry to cushion the possibility of future losses. The fallacy of this concept is that it contemplates that the favorable trends of the recent past in mortality, investment return and improvements in technology which have held the cost of life insurance and annuities down will continue indefinitely.

It must be remembered, however, that life insurance and annuities (also non-cancellable and guaranteed renewable accident and health insurance) are long-term business for which prices and renewability are guaranteed for many generations. Just as the relatively high interest rates of the 1920's gave way to lower rates in the 1930's and 1940's, so could today's rates fall even further in the future than they already have.

Mortality has improved continuously almost since it has been measured. Will the improvement continue indefinitely, or will environmental hazards or war or an epidemic cause companies to have to use their "surplus" to cover their losses?

Even recent inflation has not, as yet, caused the life insurance industry to suffer losses, primarily due to the fact that so far, the industry has benefited significantly from the reduction in cost through computer technology. It is questionable whether this trend can be expected to continue indefinitely.

Yet, it is a fact that, for competitive reasons, life insurance companies must price their products based upon today's most favorable conditions. For nonparticipating policies especially, the companies accept a risk that these conditions will continue for the life of the policies issued. For whole life policies, this can be as long as 100 years. Alternatively, companies have gone to offering flexible premium investment-oriented contracts which shift the investment risk from the company to the policyholders. Certainly, the deductions that were contemplated in the '59 Act are just as appropriate today for long-term non-participating policies as they were then. We suggest, therefore, that the Proposal be modified to permit the special deductions for policies which meet strict definitions of long-term rate and renewal guarantees. Such definition would include:

1. Rates guaranteed per unit of face amount of coverage.
2. Renewability guaranteed to the endowment date.
3. Rates not subject to dividend or investment participation.
4. Policy endows for the full face amount.

For health insurance, guaranteed renewability to age 65 (or 5 years if longer) should satisfy the long-term requirement.

We suggest that policies which qualify under definitions such as these be eligible for the special non-par deduction, as well as for deferral of Phase III tax on the income attributable to them (under some basis of approximation not requiring a separate calculation of underwriting profit for them).

Special Deduction for Nonparticipating Policies

Mutual insurance companies charge premiums which reflect some redundancy to cover unexpected expenses, etc., which redundant premium is returned to policyholders in the form of policyholder dividends when not needed to cover these expenses. These are called participating policies.

Most of the business written by stock companies are "nonparticipating policies" which do not provide for a return to the policyholder of any portion of the premium and as a result, have lower annual premiums. Thus, while mutual companies can accumulate funds to provide against potential adverse mortality or earnings experience through these redundant premiums, stock companies must provide against these adverse expenses by placing their owners' earnings and capital at risk.

In recognition of this differential, the '59 Act permitted a special deduction equal to 3% of nonparticipating premiums. The Ways and Means Committee report on the '59 Act pointed out that this deduction was intended to compensate a stock company which had to provide its capital and surplus accounts out of taxable income, while mutual companies could accomplish the same through untaxed redundant premiums.

Special Deduction for Group Life Insurance and Individual Accident and Health Contracts

Because group insurance generally provides that an insurance company must accept all individuals within the group irrespective of health history, there is a less than usual diversification of risk in group policies. Companies who do not, for some reason or another, write group insurance, may write individual accident and health insurance contracts. Often, there is adverse selection in the sale of individual accident and health insurance contracts in that those individuals with poor health histories will take the coverage, while those with good health histories will not. Thus, whether the company sells the group life, individual or group A&H, they are subject to anti-selection.

In recognition of the need to protect stock companies from the higher than normal risks they take in issuing both group insurance and individual accident and health contracts, the '59 Act provided for a deduction of 2% of certain group insurance and individual accident and health contracts in calculating taxable income of the companies.

We understand that the Taxable Income Adjustment was meant, in part, to replace these special deductions. However, the Taxable Income Adjustment has no direct relationship to the liabilities an insurance company incurs by selling these types of policies. The deductions should be more closely allied to the policies themselves.

Computation of the Deduction for Reserves

Several issues come to light from a review of these provisions.

Net Level Revaluation

We are able to understand the Committee's concern about the recent development of products by the insurance industry designed specifically to take maximum advantage of the deduction under the S818(c) election. We believe, however, that the Committee is overreacting when it eliminates all such elections, even for policies which are the same as the ones the S818(c) election was originally designed to accommodate properly. These policies could be defined using a very strict definition that would eliminate those that were actually term insurance camouflaged as whole life. The definition would require several components:

1. Benefits issued are level or never decrease by their terms.

2. The policy continues until some age at which time it endows for the full face amount.

3. Dividends are not paid — the policy is nonparticipating as regards all elements; mortality, interest and expenses.

Policies with this design clearly have high reserve requirements due to the true long-term nature of the contracts and the need for full funding of future endowment benefits. They require significant early funding for future increases in mortality, and perhaps, inflation or expenses. Furthermore, because the policies are issued for a long term, the allowance of a net level deduction for such policies does not give companies that issue them a relatively great tax advantage.

The use of net level reserves for taxation of these types of policies is appropriate in that these policies require early funding of long-term risks without the benefit of future premium increases, benefit decreases or dividends. If full taxation is applied in early years, the possibility exists that adverse future experience will be exacerbated by having already taxed early revenues based upon minimum reserves or cash surrender values. It should also be remembered that the use of a net level reserve does not actually result in the elimination of taxes, but only the deferral of them. Eventually, as the policy matures, the tax will be paid. In fact, the use of net level reserves only reduces taxes in the first policy year; in each subsequent year, the tax on the policy is actually higher.

The requirement that the insurance contract involved be nonparticipating is in recognition of the fact that companies which issue participating policies have an added cushion in the form of redundant premiums on which dividends are anticipated to be paid, which cushion reduces the need in the early years to fund future adverse experience.

General Reserve Requirements

The requirement that companies use, for tax purposes, full preliminary term reserves based on the most recent mortality table and the highest interest rate allowed under state law has several problems.

1. Use of full preliminary term reserves means that, for some policies, companies would be taxed on a reserve that is less than the minimum required by state law. The minimum reserve is that using the "Commissioner's Reserve Valuation Method". Essentially, this method is equal to full preliminary

term for policies with premiums less than twenty pay life, but for policies with higher premiums, a greater reserve is required. We, therefore, recommend that this provision be modified to describe the reserve as the **Commissioner's Reserve Method.**

2. Use of the highest assumed interest rate permitted under state law would have similar ramifications. Currently, the NAIC model life valuation law provides for a change in the maximum interest rate **allowed** every year. Companies that do not wish to or cannot afford to change their policies each year generally select an interest rate comfortably below the current maximum so that if the maximum rate drops in later years, they are not required to undergo **expensive modifications** to their policies.

3. Use of the most recent mortality table allowed by state law would create immediate difficulties for many companies. A bit of background is important here as regards the concepts by which states have adopted new mortality tables. When a state adopts a new table, it generally specifies a period during which companies may make options whether to use the new tables or continue with the old one. This is done to permit companies that do not plan to make significant changes to their product portfolio in the near future sufficient time to change administrative systems to accommodate the new table. Changing to a new table is **very expensive** and a company that developed a new portfolio just prior to the adoption of a new table would be seriously hurt by being required to once again redo its portfolio using the new tables.

   In order to get full industry support of adoption of new tables, states, therefore, have incorporated a period of time during which the use of the new table is optional.

If the tax law **requires** the use of the new table, two undesirable results will occur.

a. Companies will be required to spend considerable sums of money in order to be able to calculate reserves on the **allowed** basis.

b. There will be little or no motivation for the industry to support states' development of updated mortality and interest tables.

These considerations are especially important for companies that have segments of their business which are sold in small volumes. It costs the same to convert a small group of policies to new interest/mortality tables as a large group. It is, therefore, an **extremely onerous burden** to require companies to use the most recent interest and mortality tables allowed.

Permitting a company to use any mortality table allowed at the time the policy is issued should not be detrimental to the objectives of the tax law. When new tables are introduced, the old tables are not continued indefinitely, but only for a period of time long enough for companies to convert when most beneficial economically. Further, because of the impact on statutory surplus, there is strong financial motivation to move to the new table as soon as it becomes economically and administratively feasible.

Similarly, the use of lower interest rates than the maximum allowed by law should not impair the intent of the tax law since companies will want their policies to be up-to-date to avoid incurring more surplus strain than necessary.

In addition, the requirement that the reserve used for tax purposes be based on the highest rate and most recent table that could be used in the state in which the contract is issued will result in companies being taxed on a reserve **lower** than the minimum required by law for them. This will occur whenever the company's state of domicile requires a greater reserve than that required by the state in which the contract is issued. The domiciliary state will not permit a company to hold reserves less than its minimum, regardless of the law of the issue states. The requirement ought to at least be changed to the **greater of the reserve required in the state of issue or the state of domicile**. This change would not, however, afford any actual administrative relief to companies noted in the section entitled "Administrative Burdens".

We, therefore, recommend that the Proposal be modified to permit use of the **same mortality and interest rate as used for statutory purposes**. As to the method, we recommend the **Commissioner's Reserve Method** instead of Full Preliminary Term (except as noted in our discussion of net level revaluation).

Effective Date of Reserve Revaluations

We suggest that any changes to the reserves allowed under the tax law be for policies issued in future years only. We believe that disallowing previously allowed reserve changes is unfair and also presents a significant administrative problem for most companies.

In pricing insurance products, companies take into account long range assumptions as to mortality, interest, expenses and taxes. A whole life policy issued in 1983 to a newborn child could conceivably be in force until the year 2082. The actuary must project all elements associated with that policy, including the tax burden or savings associated with it. There are many policies sold today which could not be sold at their current price if they are to be taxed on the new basis contemplated. These policies were designed to take greatest advantage of the impact of the '59 Act. They were sold in good faith that the tax applied to them would remain consistent. Specifically, the amount and, as important, the timing of the tax will be significantly different under the new law. If this new tax basis is applied to old policies, companies that issued these policies will be put into the position of forever losing money on this business. While we are not privileged to any information about other companies' financial situation, we would surmise that several companies would become **totally unprofitable** for the business already on the books. The company would have no motivation to continue operating since it would face future deficits for as long as it continued on existing policies. Again, this problem is greater for companies with nonparticipating policies which do not afford the company the ability to reduce future dividends as the means by which to offset future increased taxes.

There is another consideration which makes it inappropriate to apply the change retroactively to existing policies. Many companies have policies in force that are more than 50 years old. They would be required to undergo significant administrative expense in going back and first determining the applicable interest and mortality table for each policy and then recalculating the allowable reserve. The procedure costs the same virtually regardless of the number of policies involved due to the enormous requirement for changing systems to calculate reserves. Many companies do not even have access to the tables applicable since many of these policies were reserved manually. This aspect is more fully discussed in the section on Administration Burdens in Section II of these Comments.

For both these reasons, we urge that the Committee consider making the reserve requirements changes applicable on **a prospective basis only.**

Additional Reserves for Accident and Health Contracts

The Proposal deals with the accident and health policies very briefly. It states that:

> "With respect to accident and health insurance contracts, unearned premiums and unpaid losses would continue to be computed as under present law."

No mention is made of additional reserves required for the special guarantees of rates and renewability under guaranteed renewable and non-cancellable guaranteed renewable contracts. We presume that the Committee intends to treat these reserves in the same way — as computed under present law.

Taxable Income Adjustment

If the general scheme of taxation, as proposed, is ultimately made into law and the Committee recognizes that the level of taxation generated by the Proposal is too high, the Taxable Income Adjustment can be used to adjust the level of the tax burden. The Taxable Income Adjustment can be made larger or smaller, depending on the need to produce revenue. This potential "time bomb" will not allow the industry to confidently or accurately do its financial planning, especially stock companies that do not have the ability to adjust future dividends to offset tax adjustments.

Tax-Exempt Income

The Proposal preserves the allocation of tax-exempt income between the company and the policyholders. Anyone familiar with life insurance company taxation knows that allocating a portion of tax-exempt income to policyholders results in a portion of that tax-exempt income actually being subject to tax, the so-called "Atlas effect".

If it is the intention of the Proposal to tax life insurance companies under ". . . the tax rules applicable to corporations generally . . ", it is inappropriate to keep this allocation as a part of any new law. There are at least two major reasons for dropping this portion of the Proposal:

1. If the allocation were retained, then much of the complexity of the '59 Act would not have been done away with, as the very involved computations to arrive at the company's share would still be required. Nothing is said in the Proposal as to the computation required, but it would certainly complicate what was posed as a simple routine.

2. More importantly, the life insurance industry is currently the only industry that does not get **a full deduction** against income for **tax-exempt income**. This part of the Proposal perpetuates that inequity. The life insurance industry should be treated as all other industries in relation to the deduction of the tax-exempt income.

Tax-exempt income should not be required to be allocated between the company and the policyholders, but should be fully deductible in arriving at taxable income.

Based on the treatment to be afforded individual policyholders, only truly taxable investment income should be attributable to the policyholders' share. Under the Proposal, the individual policyholder is actually being taxed on what Congress has already deemed to be tax-exempt income.

Previously Deferred Amounts

The '59 Act created a memorandum policyholders' surplus account. That account was increased on an annual basis by the 50% deferral of the excess of gain from operations over investment income, the deduction for nonparticipating contracts and the deduction for accident and health and group life insurance, the items that were meant to allow a buildup of sufficient protection to allow full payment of claims when due. The policyholders' surplus account was maintained only by stock life insurance companies.

The Proposal does away with all the items that went into building up the policyholders' surplus account. The Proposal does not contain any provisions as to what happens to the accumulated account. Four possible options were being considered. They include:

1. Recapture over a set period.
2. Loss Offset.
3. Recapture as policies terminate.
4. Recapture under current rules.

We will comment on each option as presented.

1. Recapture Over a Set Period

This is the worst option for the life insurance industry, and its policyholders as well. It has been suggested that the existence of this account and its elimination will only impact a relatively small number of large stock life insurance companies. This is simply not true.

All stock life insurance companies are required to maintain such an account regardless of its size. There are approximately 1,900 stock life insurance companies operating in the United States. That means that there are 1,900 separate policyholders' surplus accounts in existence. If the accumulated balance in this account is recaptured, it will be recaptured from all of these companies, regardless of size.

In order to gauge the impact of a possible recapture of the policyholders' surplus account on stock companies, we contacted several companies and discussed the impact of a recapture on the statutory surplus of the companies. Some of the companies surveyed had accumulated balances in their policyholders' surplus accounts that equaled 10% to 20% of their assets. If this balance were recaptured at the current rate of 46%, the assets and surplus of these companies would be seriously impacted. In one company's case, assets would go down only 5%, but surplus would be reduced by **almost 75%**, and this could easily result in the **insolvency** of the company. Even though the greatest impact would be on smaller companies, the larger companies are not unaffected. Several companies with assets over $1 billion ($2.6 billion in one case) would have their surplus depleted by 25% if they were required to pay tax on their policyholder surplus account.

Many smaller stock companies would be in serious danger of **complete insolvency**, and many medium and larger companies would experience **impaired solvency**. This could impact at the state level in several ways. If a company were to become insolvent, its policyholders could be left without the insurance protection they bargained for when they purchased the insurance. Most states have established Guaranty Associations. The purpose of these associations is to ensure continued coverage to the policyholders of an insolvent company. This continued coverage is provided by assessing all remaining companies doing business in the state for the amounts necessary to continue this coverage. As a result, any insolvency resulting from a change in the mode of taxation would fall on the rest of the insurance industry with the result that their expenses would be increased, which could decrease their profits, resulting in a new round of insolvencies, and so on.

Although this is, perhaps, carried to the extreme, it is illustrative of the far reaching nature of any major changes in the mode of the taxation of the life insurance industry.

2. Loss Offset

The major problem with this option is that losses generated in the future have nothing to do with the purposes of the policyholders' surplus account. This would be a case of the proverbial "mixing apples and oranges".

3. Recapture as Policies Terminate

This option makes more sense than either of the first two. It more closely ties the policyholders' surplus account with the items for which it was created — the policies and the policyholders. The problem with this option is that it could be very complicated to administer. As the goal of the Proposal is simplicity, it seems inappropriate to select an alternative that would result in undue complexity.

4. Recapture Under Current Rules

This is the best option. The rules for recapture are established and understood. They are simple to calculate and administer.

Some commentators have suggested that none of the accumulated balance in the policyholders' surplus account has been subject to recapture under the current rules. That is **simply not true.** Several companies, large and small, have had a recapture of a portion of their policyholders' surplus account under the current rules. Over the last ten years, two of the companies in the Combined Group have paid **$5.5 million in Phase III taxes** as a result of recapture from the policyholders' surplus account.

Conclusion

Any recapture of the policyholders surplus account should be accomplished using the current rules.

II. Deferral of Enactment of Proposal

Several reasons exist why the effective date of the Proposal should be deferred.

Complexity

The majority of the speakers at the hearings of the Select Revenue Subcommittee suggested that one of the reasons for changing the taxation of the life insurance industry was because the '59 Act was too complex. It must be recognized that it will appear more complex to those who do not work with it on a daily basis than it is to those who specialize in insurance company taxation, much the same as the taxation of regular corporations would appear complex to a general office worker in that same corporation.

We do not mean to suggest that the Act is not complex at all. It is!! However, it merely reflects the complex nature of the life insurance industry. There is probably no other industry in the United States that is more complex on an overall basis. According to the 1982 Life Insurance Fact Book published by the American Council of Life Insurance, the life insurance industry provided $4,063,595,000,000 (**$4 trillion**) of life insurance protection and $24,474,000,000 (**$25 billion**) of accident and health benefits to **150 million policyholders** in the United States in 1981, 96% of whom are of adult age. The average life expectancy of a male in the United States in 1980 was 69.8 years and 77.5 years for a female. Providing life insurance, accident and health insurance and annuity protection to **two-thirds** of the United States' population that could be expected to live as long as 77 years almost automatically results in a complex business. Thus, due to the very nature of the business, its scheme of taxation unavoidably results in a certain degree of complexity.

Although on its face, the Proposal appears quite simple, we submit that its apparent simplicity is a result of its lack of attention to the details of how it will be implemented. There are several questions and techniques that are unanswered by the Proposal. A few are:

1. If there is to be no policyholders' share of investment income computation, how will the company's share of tax-exempt income be calculated?

2. We presume that when the Proposal states that accident and health unearned premiums and unpaid losses will continue to be computed as under present law, all A&H reserves are included.

3. When the Proposal states that ". . . funds held with respect to contracts that do not involve permanent purchase rate guarantees would not be treated as insurance reserves", is this limited to annuity contracts only?

4. Do the rules for a life insurance company's participation in a consolidated tax return stay the same or, now that they are to be treated like other companies, will the artificial limits on life-nonlife consolidated returns be removed?

5. Is the definition of life insurance, which speaks only to policyholder tax treatment, also meant to apply to life insurance company tax treatment?

We believe that a longer thought process is necessary in order to put together a complete Proposal that will not be subject to continual technical amendments. If the areas in doubt are not clarified before the Proposal becomes effective, it could result in the industry and the IRS being in total confusion as to the application of the law. Tax certainty would be better served by a delay.

Administrative Burden

We believe the framers of the Proposal do not fully appreciate the administrative burdens created by the Proposal. As noted earlier, under the Proposal, companies are required to revalue all reserves under the new rules for tax purposes as of January 1, 1984. The reserve revaluation is to be the higher of the actual surrender value or the minimum state law reserves. The latter is defined as the reserve required if the company used:

1. A full preliminary term method,

2. The highest assumed interest permitted, and

3. The most recent mortality table allowed.

Items 2 and 3 are fixed as of the year the contract was issued.

One of our companies has been issuing life insurance policies since 1928. It has approximately **1,000 active, separate policy forms,** many of which were issued over 25 years ago. In the last 15 years alone, there have been three separate mortality tables allowed and as many as 10 different interest rates allowed. Even with the use of the most modern computers, such revaluation would require a significant investment of man-hours and computer time. There is a serious question of whether these revaluations could be accomplished in the time required without a complete shut-down of the normal operations of at least the actuarial and data processing departments.

Our Actuarial Department has indicated that for purposes of calculating the restatement of reserves alone, they would have to investigate 700,000 cell combinations of plan issue ages and years over a 20-year period. This would result in **14,000,000 separate reserve computations** for our company alone.

A careful reading of the Reserve Computation section discloses a potential administrative burden of even greater proportions. It states that these recomputations are to be made:

> ". . . at a time the contract is issued **in the State in which the contract is issued.**" (Emphasis added)

Taken literally, if a single policy form is issued in each of the 50 states, there is the potential of 50 separate computations being required for that policy form alone. Carrying this separate state argument to its extreme, if separate state computations were required for just the restatement, we would have to make 70,000,000 separate reserve computations. If only 25% of our company's experience is accurate for all life companies (our insurance in force is significantly lower than that of the largest companies), the almost 2,000 life insurance companies would be required to make 35,000,000,000 **(35 billion)** computations in order to complete the January 1, 1984 recomputations alone.

Product Redesign

As discussed, in pricing insurance products, actuaries consider the mode of taxation in addition to mortality, morbidity, income and other factors. All products issued since 1959 have taken the '59 Act mode of taxation into consideration.

The Proposal would require them to take a completely new, higher taxing mode into consideration. Products being designed today will, for the most part, be sold **after the effective date** of the Proposal. This demands that the actuaries, in pricing those products today, **must** consider the new taxing structure, yet they **do not yet know** what that new taxing structure is actually going to be.

Considering the general legislative process, it is not likely that the specifics of any new taxing structure will be known to the actuaries until sometime in the late **3rd quarter** or **early 4th quarter** of **1983.** It would not be possible for actuaries to then restructure their entire pricing procedures in time to have new products priced so as to consider the new taxing structure in sufficient time to allow for the appropriate buildup of reserves, etc. needed for proper policyholder protection. They would be required to build new models, data processing procedures and the like in order to complete the pricing process. This takes more time than the actuaries would have available to them. (See also, Regulatory Constraints, below.)

If the effective date of the enactment of the Proposal is not postponed, it is very possible that there could be a **complete halt in new product design** until such time as the Proposal was finalized, completely understood, models built, computer programs designed and computations made. This could very easily run well into the year 1984. Because products designed prior to this date considered the old taxing structure, the earnings on those products will be decreased (significantly in some cases) because of the new structure cutting into (significantly in some cases) the insurance companies' profit margins. In some cases this could even result in losses. Insurance companies might remove previously designed products from the insurance market. Carrying this scenario to its extreme, there is the possibility of **only a limited number of insurance products being available** for marketing for some period of time into 1984. This would result in a loss of protection, as well as a **loss of jobs, revenue, additional taxes and the like.**

In addition, the proposed increased tax burden is coming at a time when life insurance companies are still being affected by **the economic recession.** The increased tax burden and administrative costs could conceivably bankrupt smaller insurance companies, which in turn adversely impacts other companies through State Guaranty Associations.

If the effective date of the Proposal were deferred at least one year after its final enactment, the product redesign could be completed in an orderly manner with a continuing flow of appropriate products.

Regulatory Constraints

Because of the change in the Proposal and its economic impact on products and pricing, as we noted, it would be necessary to redesign the products. Because insurance is a **regulated industry**, all of those redesigned products would have to be submitted to the State Insurance Departments for approval. A company that sells products in all 50 states would be required to submit those new products in each of those states for approval on an individual state and individual policy basis.

With the State Insurance Departments being deluged with newly designed products, it is not reasonable to assume that the regulatory approval for the sale of those products would be quickly forthcoming. It is not inconceivable that the approval of those products could take as long as ten to twelve months, or even longer in certain cases.

Without regulatory approval, the products cannot be sold. Unfortunately, the insurance companies do not have control over the regulatory approval. It is clear that state budgets are currently overburdened and the states would not be in a position to put on additional staff in order to handle the approval of all of these redesigned products.

Policy Reprinting

Not only would new products have to be redesigned and submitted to the State Insurance Departments for approval, but once approved, the policy forms would have to be reprinted. All old policy forms would have to be scrapped. Our companies estimate that the costs associated with this reprinting and scrapping would be approximately $600,000.

Conclusion

Because of the complexity of the taxation of insurance companies, the administrative burden that any new law would create and the need to redesign products, have them approved by State Insurance Departments and reprint policy forms, we believe that the effective date of the Proposal must be postponed for a longer period of time after its actual enactment.

III. Level of Taxation

Introduction

Tax Burden of Life Insurance Companies Should Be Compared to Tax Burden of Other Industries

The estimates of the level of taxation to be generated by the "Description of Life Insurance Income Tax Proposal" (Proposal) vary greatly. The Proposal suggests that overall

> ". . . the proposal would generate revenue of several hundred million dollars less than the revenue estimates projected for the expiration of the temporary provisions (in TEFRA) . . ."

Those revenue estimates were about $4.7 billion. It is projected that the insurance industry would have a tax burden of $2.3 billion in 1983. Even if the Proposal resulted in a tax burden of as little as $4.5 billion, which has been estimated by the ACLI to be the minimum impact, this would result in an increase of 95% in the industry tax burden. This level of increase is unfair to the insurance industry.

The Committee should not look at the insurance industry in a vacuum when creating a new tax structure. It is more appropriate to consider the tax burden of the insurance industry in comparison to other industries in establishing any new taxing structure.

Total Dollars Paid

Life Insurance Industry's Tax Burden Has Increased More Than Other Industries Reviewed

The insurance industry is a major industry in the United States. It has paid significant tax dollars since the inception of the current mode of taxation of the life insurance industry. A review of Exhibit A indicates that over the fourteen-year period from 1966 through 1979, the taxes paid to the Internal Revenue Service by the insurance industry, which for this Exhibit includes stock and mutual companies, increased from $800 million to almost $3 billion, or an increase of almost 275%.

In order to make major industry comparisons, we reviewed the Internal Revenue Service's annual Publication 16 entitled "Statistics of Income—Corporation Income Tax Returns". The following segments of the IRS report were reviewed:

1. All Active Corporations
2. Manufacturing Corporations

3. Service Corporations

4. The Financial Industry (as a total)

5. The Banking Industry (included in 4)

6. The Life Insurance Industry (included in 4)

With the exception of the service industry, the tax burden, after credits, increased more for the life insurance industry than any of the other industries reviewed. The following table shows a comparison of the percentage increase in tax burden, by industry, for the fifteen-year period ended 1980.

	Percent Increase 1966 - 1980
All	118.3
Manufacturing	101.1
Financial Institution	156.1
Service	273.8
Banks	91.5
Life Insurance	159.6

The enormity of the insurance industry tax bill caused many insurance companies to engage in a "self help" program, the major component of which was the use of reinsurance with a §820 Election. The impact of that program can be seen in the taxes paid in 1980, which fell to $2.1 billion. As noted earlier, this was one of the major reasons for the repeal of §820 in TEFRA and the other changes that were contained therein. It is important to note that actual dollars of taxes paid decreased from 1979 to 1980 in every industry reviewed except for the service industry, where there was a 7.9% increase.

A comparison between the tax burden of the banking industry and the life insurance industry lends itself to a meaningful comparison. The banking industry is the life insurance industry's closest competition for the consumers' saving dollars.

Exhibit B compares the actual dollars of tax after credit for the banking and life insurance industries and illustrates the ever-increasing burden of the life insurance industry. It is interesting to note that in 1975, the banking industry's tax burden in actual dollars was **less** than it was in **1966**.

In 1966, the banks paid $851 million in taxes after credits, while life companies paid $809 million, or 5.1% less than the banks. In 1967, banks also paid more taxes after credits than life companies. However, beginning in 1967 and continuing through 1980, life companies paid more taxes after credits than banks at an ever-increasing rate. For the fourteen-year period ended 1979, the life insurance industry's tax burden after credits increased from $809 million to $2.9 billion, an increase of 268%, while the banking industry's burden increased from $851 million to just under $2 billion, for an increase of only 130.1%. **Thus, the life companies' taxes increased more than twice as much as the banks' taxes.** Even when 1980 is included, the life companies' taxes increased 159.6%, while the banks' taxes increased only 91.5%, a 1.7 times greater increase for life companies.

Insurance Industry Share

In deciding whether the insurance industry is carrying its fair share of the corporate tax burden, it is important to first understand what share it actually pays. There are several ways that share can be measured. They include:

1. Tax as a percent of Assets
2. Tax as a percent of Receipts
3. Tax as a percent of Taxable Income

Tax as a Percent of Assets

Difference Between Life Insurance Industry's and Other Industries' Taxes Not Material

Exhibit C shows a history of the percentage of income taxes before credits by these six segments. At first glance, it might appear that the insurance industry actually fares fairly well. These figures, however, are deceiving in that although the manufacturing industry is capital intensive, i.e., it must have very large quantities of assets in order to generate receipts, the life insurance industry includes accumulated reserves in assets even though these intangible assets are earmarked and are not generally allowed to be used for generating operating income. As a result, the life insurance industry has an asset base that includes "non-productive" assets which are compared to the taxes paid. In addition, because of the large tangible asset base, these capital intensive industries can more fully utilize the income tax credit provisions of the Internal Revenue Code, such as the investment tax credit.

A comparison of Exhibit C with Exhibit D bears this out. In Exhibit C, for the period 1976 through 1978, for example, the manufacturing industry paid approximately 4% of its assets in taxes, all active corporations paid somewhat less than 2% and the insurance industry paid about .5%. Exhibit D shows the impact of the greater utilization of credits by the capital intensive industries. For that same period, the manufacturing industry paid taxes, after credits, equal to about 2.7% of its assets, all corporations, about 1% of its assets and the insurance industry still paid about .5% of its assets in taxes. Thus, it can be seen that the income tax credit provisions of the Code does not favor the insurance industry.

When you accept the fact that the life insurance industry includes "non-productive" intangible assets, such as reserves in their asset base for making these comparisons, the differences between the life insurance industry's and other industries' taxes as a percentage of assets is not so great.

Tax as a Percent of Receipts

Life Insurance Industry Paid Largest Percentage of Receipts in Taxes

Exhibits E and F show that part of total receipts which are allocated to income taxes and what is paid out in taxes. In Exhibit E, we see that the percentage that income taxes before credits are of total receipts is much closer for all the segments reviewed. For the manufacturing industry for the 1976 through 1978 period, it hovered around 3.1%, for all active corporations, around 2.7%, and for the life insurance industry, from 2.6% to 2.8%.

The impact of the utilization of tax credits is more dramatically shown by a comparison of Exhibit E to Exhibit F. In Exhibit F, the life insurance industry jumps to the top with its 1976 to 1978 percent being 2.4% to 2.6%, while manufacturing drops to 2.0% to 2.2% and all active corporations falls to a low of about 1.5%.

This means that the life insurance industry actually paid the largest percentage of its receipts out in taxes of all the industries reviewed.

Tax as a Percent of Taxable Income

Life Insurance Industry Paid Largest Percentage of its Taxable Income in Taxes

Exhibits G and H review the percentage of taxable income paid out in taxes. Exhibit G shows that all but the service industry are bunched around the maximum tax rate of 46%. In fact, the insurance industry carries the highest burden of around 48% for the 1976 to 1978 period. This rate is higher than the maximum 46%, probably as a result of the Menge formula as originally included in the Internal Revenue Code, the impact of which is fully reviewed in the GAO Report, which resulted in the inclusion of the geometric Menge formula to TEFRA.

A review of Exhibit H dramatically shows the impact of the inability of the life insurance industry to utilize tax credits. The life insurance industry's tax as a percentage of taxable income has dropped to about 46%. All others have dropped more significantly. The manufacturing industry has dropped to between 30% and 32% and all active corporations has fallen to about 26%.

The life insurance industry paid the largest percentage of its taxable income out in taxes of all the industries reviewed.

Individual Company Burden

Life Insurance Companies' Tax Burden Increased Dramatically

Several individual companies have already estimated the impact of the Proposal on their tax liability. Estimates as high as a 400% increase in tax liability have been made.

The Combined Group of Companies has six companies taxed as life insurance companies. Although the Description of Proposal is not very detailed as to the mechanics of the Proposal, a computation was made of the impact of the Proposal on the Combined Group of Companies and was found to increase our tax liability over projected 1983 by almost **$12.5** million **(141.3%)** pro rata if there is no recapture of the policyholders' surplus account, and **$26.6** million **(301.7%)** if the policyholders' surplus account is recaptured pro rata over a ten-year period. This increase exceeds the projected increase on the industry as a whole and would adversely impact our company operations to a significant degree.

Conclusions

From these figures and computations, the conclusion inescapably follows that the life insurance industry currently bears a significant tax burden. It pays significant dollars in taxes and when compared to other industries, pays a larger percentage of its receipts and taxable income than the other reviewed industries. The level of increase proposed is unfair to the industry as a whole and to individual companies in particular.

IV. Segment Balance

The Proposal does not address the so-called "segment balance", i.e., the share of the insurance industry tax burden paid by the mutual companies and the stock companies.

Historical Background

In the Joint Committee Print, issued May 5, 1983, announcing the hearings on the taxation of life insurance companies, a table was included which, among other things, showed the segment balance since 1959, the year the current method of taxation of life insurance companies began. The following reproduces the segment balance portion of that table:

	Shares of life insurance industry tax liabilities	
Year	Mutual Share	Stock Share
1959	.650	.350
1960	.650	.350
1961	.650	.350
1962	.670	.330
1963	.670	.330
1964	.675	.325
1965	.675	.325
1966	.666	.334
1967	.699	.321
1968	.693	.307
1969	.688	.312
1970	.689	.311
1971	.686	.314
1972	.673	.327
1973	.665	.335
1974	.654	.346
1975	.658	.342
1976	.655	.345
1977	.622	.378
1978	.608	.392
1979	.600	.400
1980	.492	.508
1981	.417	.583

When the '59 Act was in formation, a conscious decision was made to establish a structure that placed approximately 2/3 of the industry tax burden on mutuals and 1/3 on stocks. For the first 18 years of the '59 Act's existence, that segment balance did not vary more than 5%.

Beginning in 1977, the mutual companies' share started to decrease more significantly until 1981, when the stock companies were paying almost 40% more tax than the mutual companies.

A review of the effect of TEFRA on life insurance company taxation cannot be done, as the 1982 and 1983 federal income tax returns of all life insurance companies are protected by the Privacy Act and are thus, not available to the general public for review. As a result, a comparison of the current tax liabilities of stock and mutual companies cannot be undertaken through a review of income tax returns.

Review of Annual Statement Information

With the desire to make such a comparison, we reviewed the Annual Statements filed with the State Insurance Departments and prepared under the auspices of the National Association of Insurance Commissioners. That review covered 75 companies. For purposes of these computations, we picked the twenty largest mutual and the twenty largest stock companies. Many of those companies are in the 50 largest insurance companies in the United States. The stock companies ranged in asset size from the smallest of almost $1.2 billion in assets to the largest in excess of $28.5 billion. The mutual companies ranged in size from the smallest of just over $1 billion in assets to the largest in excess of $66.7 billion.

A review was made of the Summary of Operations page of the Annual Statements of those companies for 1982. In particular, we looked at the relationship between the net gain from operations before dividends to policyholders and federal income taxes (line 27) to federal income taxes incurred, excluding tax on capital gains (line 30).

Stock Companies

In the case of the stock companies, four showed a negative or zero tax liability, with the lowest net gain from operations of those companies being $12,000 and the largest being $105,000. The lowest percentage relationship between federal income tax incurred and net gain from operations for the remaining stock companies was 41.7%, with 19 other companies having rates over 10%. If all of the income and taxes of these companies were aggregated, for 1982, the average federal income tax incurred as a percentage of net gain from operations is 17.1%. Dividends to policyholders represented 24.1% of net gain from operations in 1982.

Mutual Companies

When the same comparisons were made for the mutual companies, it was found that four mutual companies as well had a negative or zero tax liability. However, as contrasted to the stocks, the net gains from operations of these "no tax" companies were significantly higher. The lowest net gain from operations was $24,393,000 and the largest was $284,451,000, 2,000 to almost 3,000 times larger than the "no tax" stock companies. The highest percentage relationship for all the mutual companies reviewed between federal income taxes incurred in either year was 20.4%. Of the rest, only six were over 10%, with the remainder being single-digit percentages. When the net gain from operations and federal taxes incurred are aggregated for these companies, we find that federal taxes incurred represent 8.9% of net gain from operations in 1982. Also in 1982, dividends paid to policyholders represented 77.4% of net gain from operations.

Stock Companies Pay Significantly Higher Taxes Than Mutuals

One very important fact arises from a review of the aggregated totals for the twenty stock and twenty mutual companies. Stock companies pay, as a group, significantly higher taxes than mutuals when compared to the net gain from operations before taxes and policyholder dividends. The aggregate net gain from operations and federal income taxes incurred for the two groups for 1982 was as follows:

(000 omitted)

	Net Gain From Operations	Federal Income Taxes	Percent
Mutuals	$8,651,474	$771,001	8.9
Stocks	$2,360,510	$402,716	17.1

Although the mutuals' net gain from operations exceeded the stocks' net gain from operations by over three and one-half times in 1982, the stocks incurred federal income taxes equal to 52.2% of the mutuals.

The mutuals paid dividends to policyholders of more than ten times the dividends paid by stocks to policyholders in that year. The ability of the mutuals to pay dividends to policyholders gives them the ability to manipulate their federal tax liability so as to keep it, in almost all cases, at a single digit rate.

None of these computations consider the indirect tax burden on the stock life insurance companies, which results when the cash dividends paid to their individual shareholders are subjected to tax on the shareholders' returns.

It could be suggested that a review of the Annual Statement is not a proper place to look for a comparison of these items, as the statutory figures are adjusted in calculating the federal income tax return figures. However, the fact that this is the only information available to the public suggests that this is the best method we have for making these comparisons.

Industry Competition

Much has been said about the competitive balance between stock life insurance companies and mutual life insurance companies and we will not repeat those discussions here, although we endorse them fully. We do, however, wish to comment on some aspects of the competitive balance that have not been discussed.

Special Deductions. It should be clear that the impact of the Proposal falls most heavily on the stock life insurance companies. Even though mutual life insurance companies will have to make special computations to arrive at the amount allowed as a deduction for dividends to policyholders, it is clear that they will be allowed a significant deduction, one approaching that allowed in TEFRA. As stock life insurance companies pay a significantly smaller amount of dividends to policyholders, they have had to rely on the other special deductions to maintain any semblance of competition with the mutuals. If, as has been proposed, the special deductions for nonparticipating policies and group life and individual accident and health contracts are eliminated, stock life insurance companies will be effectively eliminated from the competition for the protection of lives. The mutuals would have little tax to pay on their income and the stocks would have a substantially increased tax to pay on their income.

The stock companies could attempt to cover this increased tax liability by increased future premiums, but any current similarity between stock company premiums and mutual company net premiums (after policyholder dividends) would disappear and the stock companies could be effectively "priced out of the market". This would be directly contrary to the basic concepts of industry competition that have resulted in benefits to the consuming public.

Policyholders' Surplus Account. Although no specific proposal was made for the recapture of the policyholders' surplus account, it must be recognized that its recapture would increase the tax burden of stock life insurance companies only. They could attempt to recapture this additional tax through increased premiums on new business or an increase in the premiums on an entire block of existing business. Again, as in the case of the elimination of the special deductions, this increase in premiums would destroy the competitive balance between stock and mutual life insurance companies.

Conclusion

It is imperative that the Subcommittee give consideration to the segment balance in its final deliberations on the Proposal.

Exhibit A

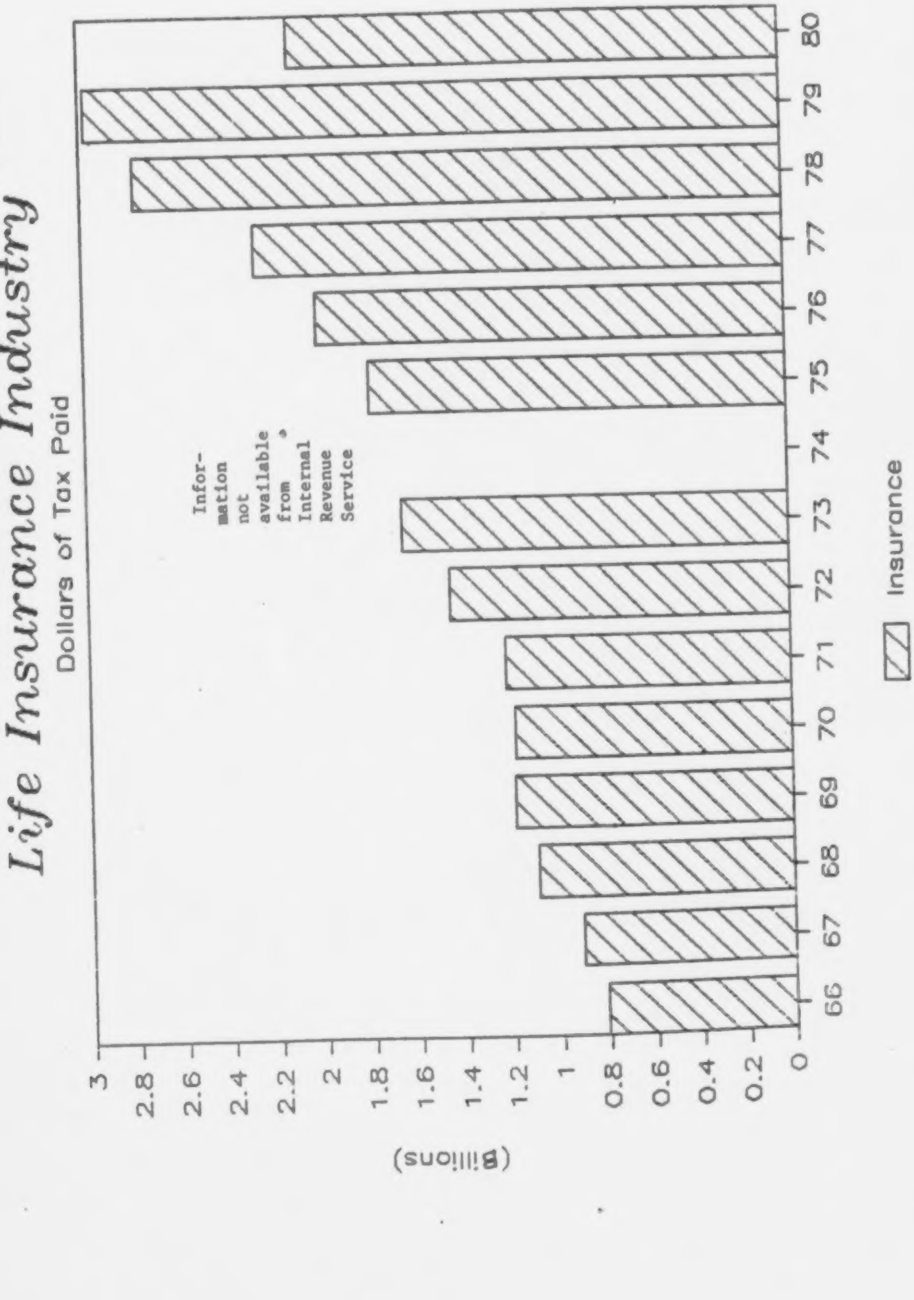

Life Insurance Industry
Dollars of Tax Paid
(Billions)
3
2.8
2.6
2.4
2.2
2
1.8
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
66
67
68
69
70
71
72
73
74
75
76
77
78
79
80
Information not available from Internal Revenue Service
Insurance

Exhibit B

Industry Tax Data

Income Tax After Credits

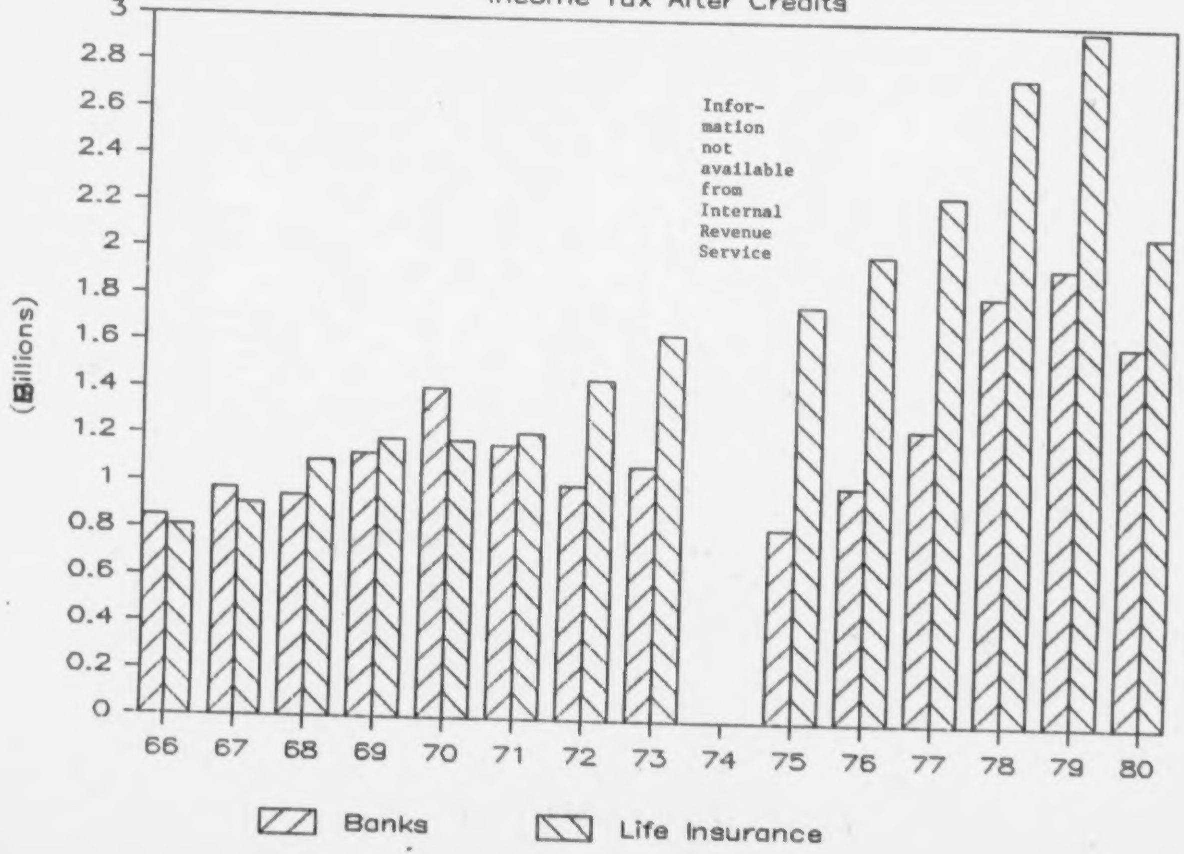


Exhibit C

Industry Tax Data

Tax as a % of Assets

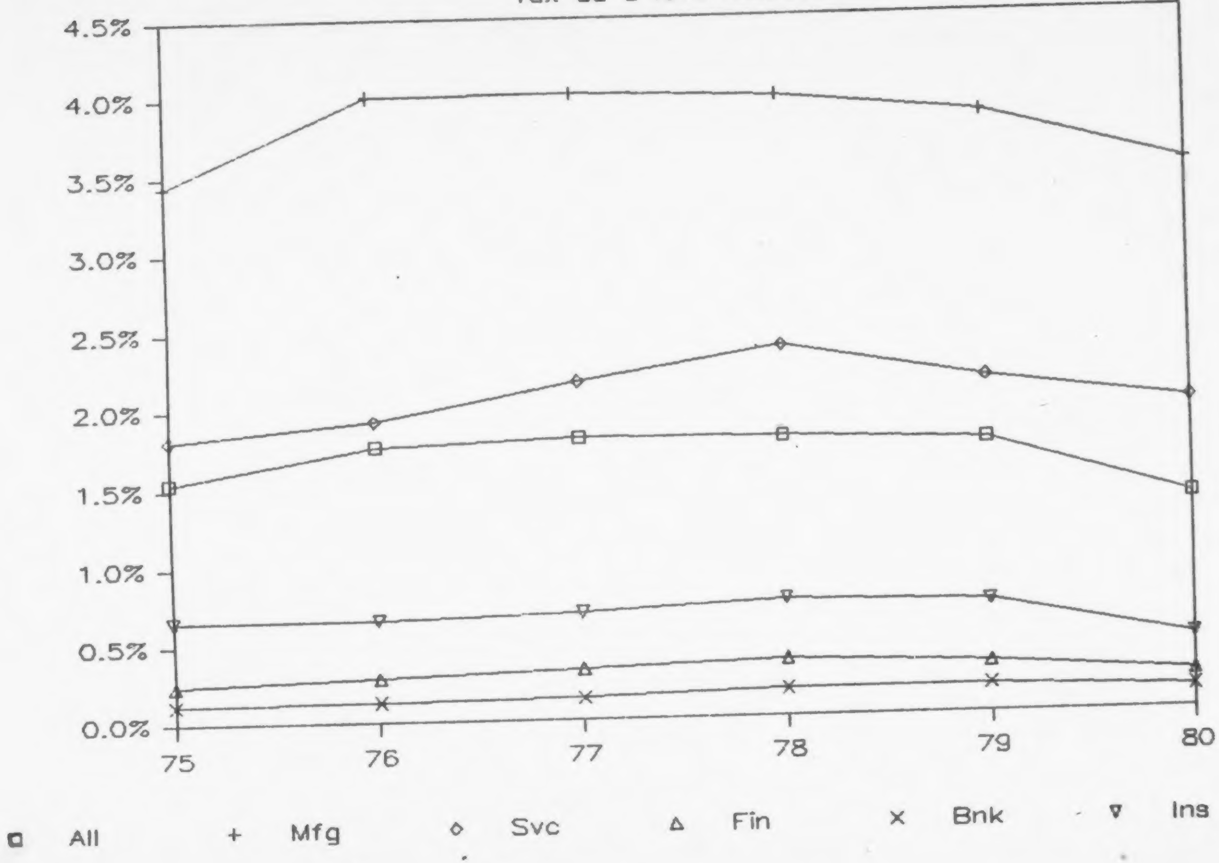


Exhibit D

Industry Tax Data

Tax after Credits / Assets

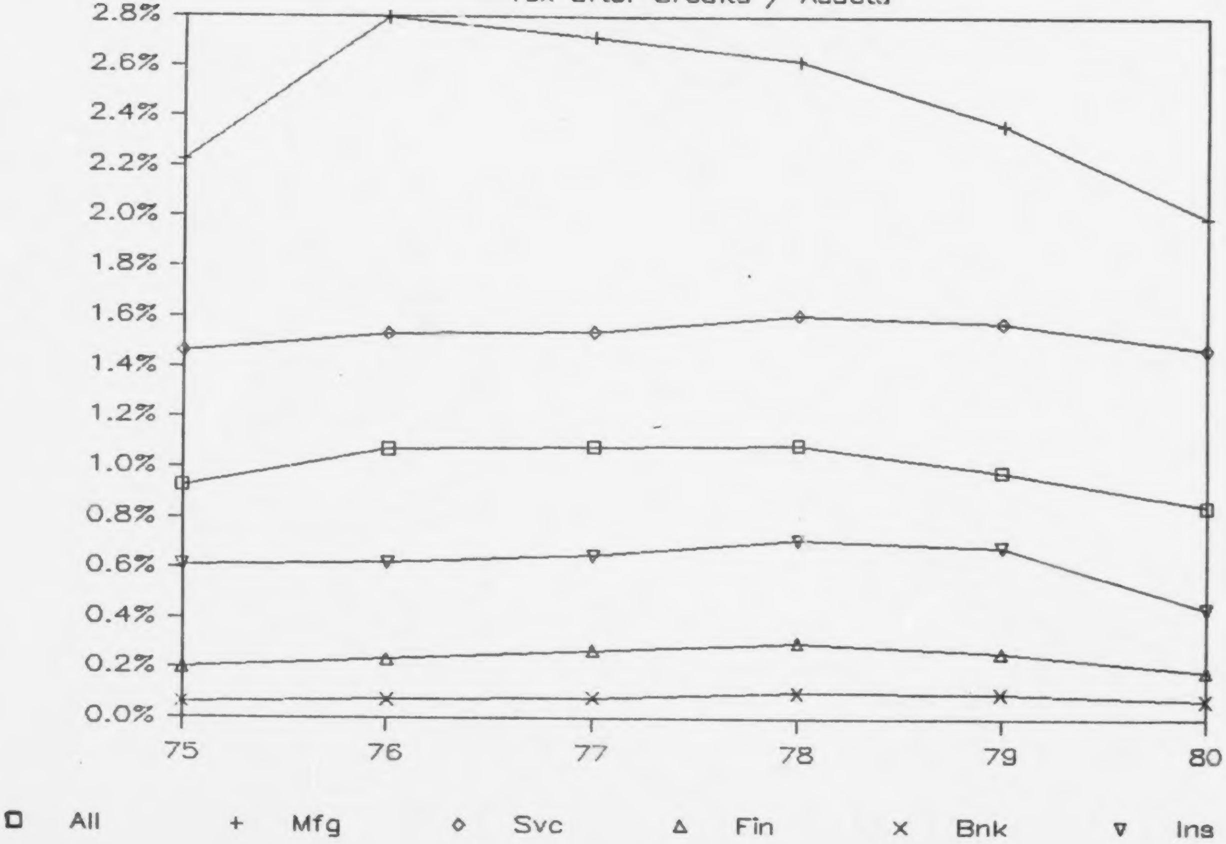


Exhibit E

Industry Tax Data

Tax as a % of Receipts

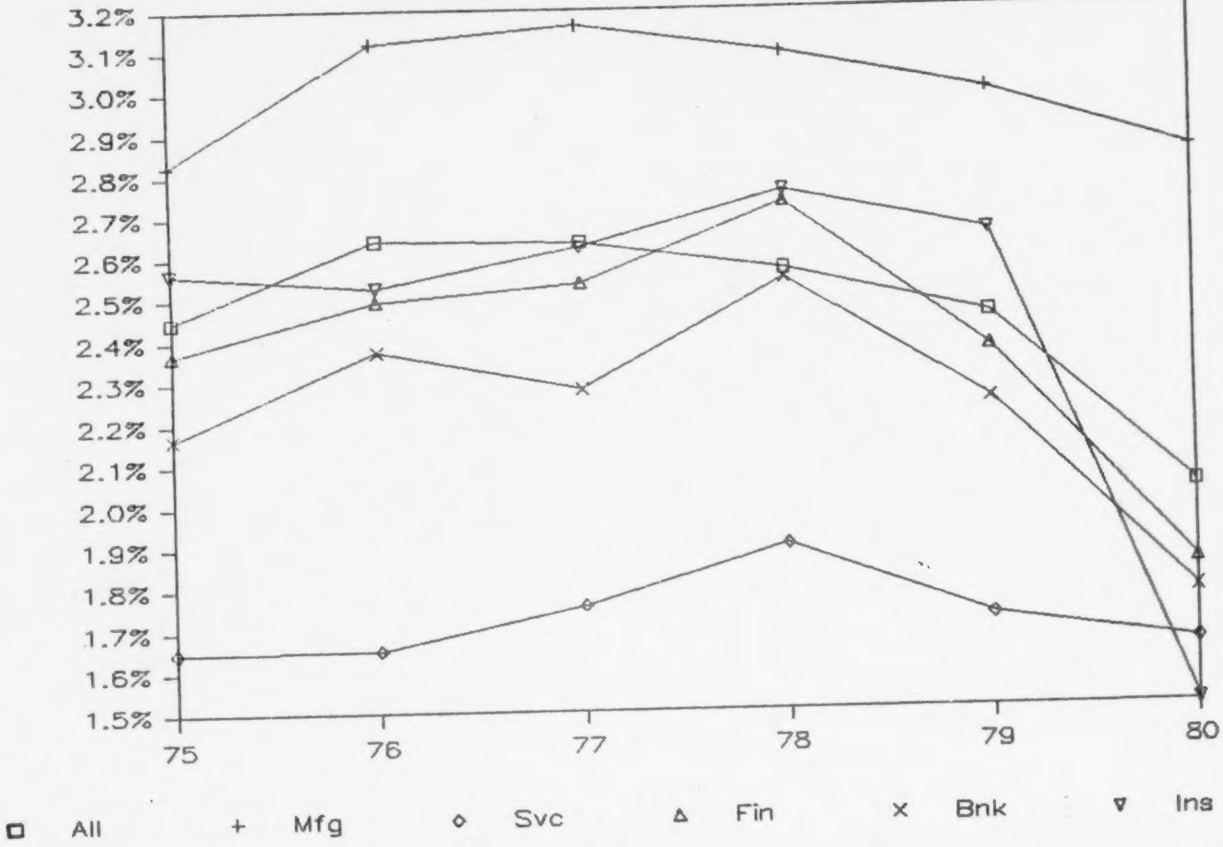


Exhibit 7

Industry Tax Data

Tax after Credits / Receipts

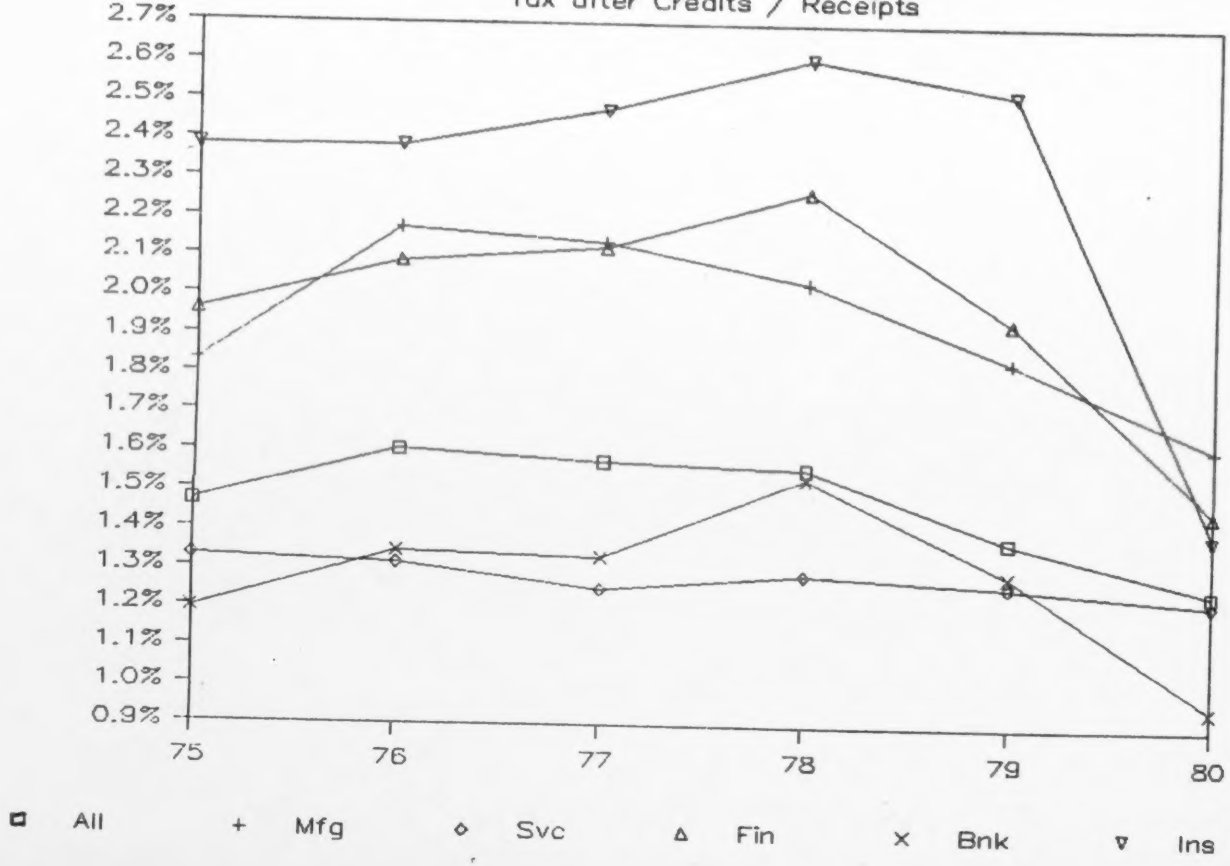


Exhibit G

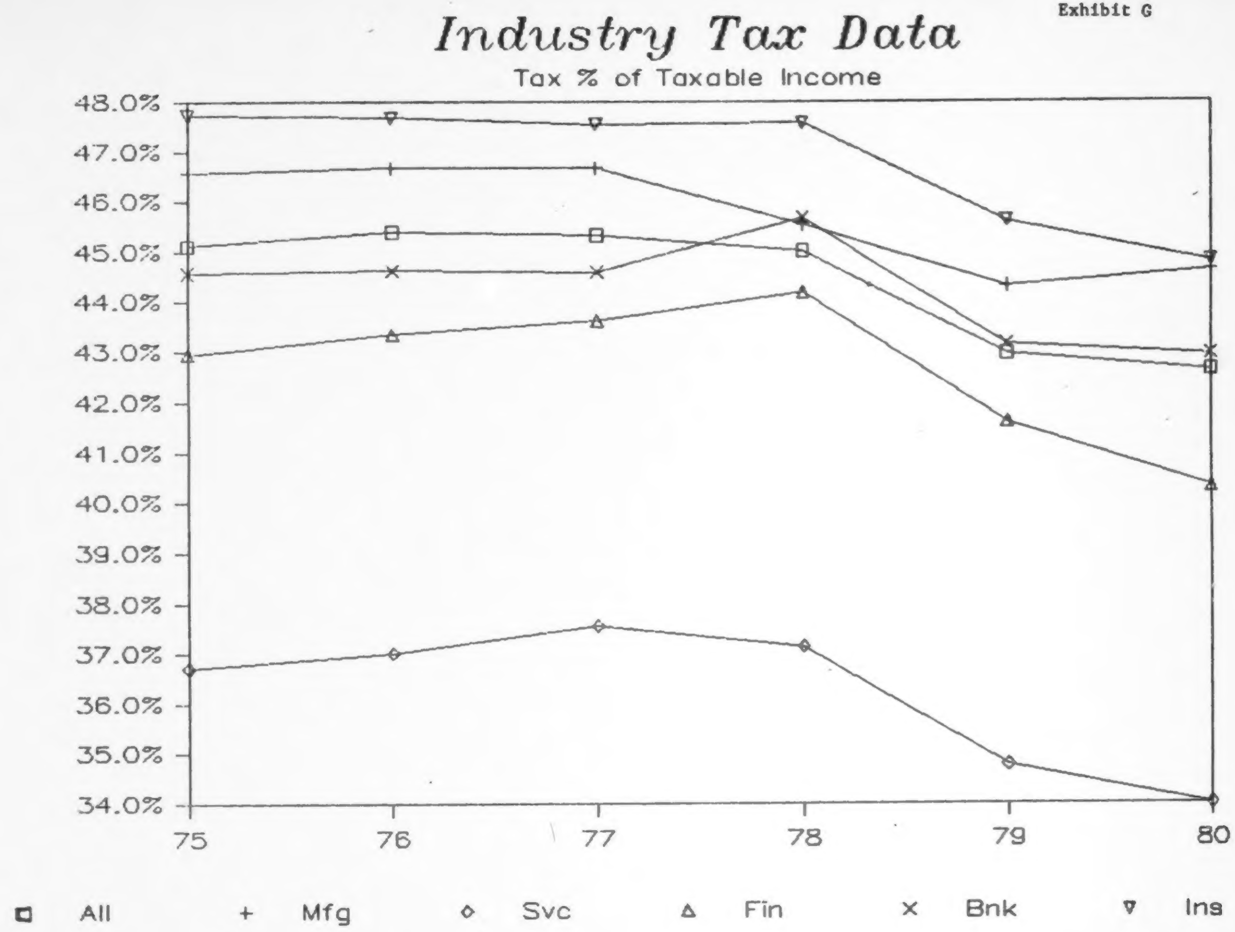
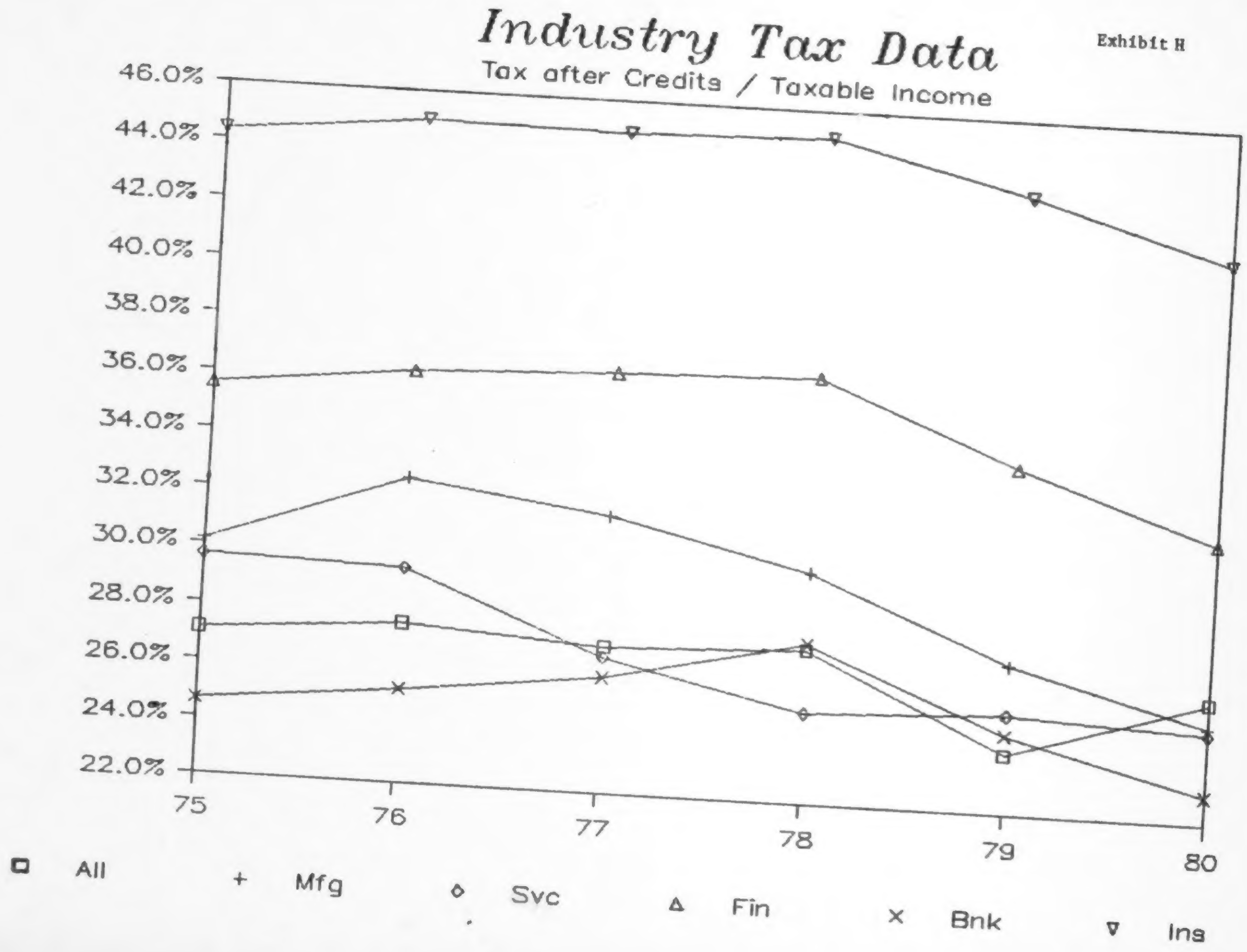

Industry Tax Data
Tax % of Taxable Income
48.0%
47.0%
46.0%
45.0%
44.0%
43.0%
42.0%
41.0%
40.0%
39.0%
38.0%
37.0%
36.0%
35.0%
34.0%
75
76
77
78
79
80
□ All
+ Mfg
◇ Svc
△ Fin
× Bnk
▽ Ins

Exhibit H


Industry Tax Data
Tax after Credits / Taxable Income
46.0%
44.0%
42.0%
40.0%
38.0%
36.0%
34.0%
32.0%
30.0%
28.0%
26.0%
24.0%
22.0%
75
76
77
78
79
80
□ All
+ Mfg
◇ Svc
△ Fin
× Bnk
▽ Ins

IMPACT OF
PROPOSED
LIFE INSURANCE COMPANY
TAX LEGISLATION
DATED JULY 14, 1983
ON
COMBINED GROUP OF COMPANIES

Submitted by:

Harvey N. Medvin
Vice President and Chief Financial Officer

Combined International Corporation
Northbrook, Illinois
(312) 564-8000

Impact on Combined Group of Companies

Increased Tax Burden

For financial statement purposes, the Combined Group of Companies projected their tax status for 1983. That projection placed them in the status of a Phase II Positive company — the Phase which most resembles that envisioned by the Proposal. Based on those projected 1983 figures, the Proposal is calculated to increase the tax burden of the Combined Group of Companies **$12.5 million**, or almost **150%**, if there is no recapture of the policyholders' surplus account on a pro rata basis and **$26.6 million**, or over **300%**, if the policyholders' surplus account is recaptured on a pro rata basis over a ten-year period.

Based on 1982 figures, the Proposal would increase the tax liability of the Combined Group of Companies over **$8** million without a recapture of the policyholders' surplus account and approximately **$22.3** million if the policyholders' surplus account is recaptured over a ten-year period.

See the Data Sheet immediately following.

Policyholders' Surplus Account

During the last ten years, the Combined Group of Companies have paid **$5,500,000** in **Phase III taxes** as a result of recapture from the policyholders' surplus account. Thus, taxes on the policyholders' surplus account are paid under present law. To recapture the account under rules other than those now in effect would increase our tax burden even more dramatically.

Administrative Burden

The Proposal will require a significant amount of manhours and computer time to recalculate reserves. It is projected that as many as 70,000,000 separate reserve computations could be required for the January 1, 1984 revaluation alone.

Most, if not all, life insurance products sold by the Combined Group of Companies will have to be redesigned and submitted to all the State Insurance Departments for approval at a significant cost in the Actuarial, Government Relations, Accounting and Policy Filing Departments. Just the cost of reprinting policy forms and scrapping existing policy forms could reach almost $600,000. That figure does not include costs associated with manpower and related expenses.

Combined Group of Companies Life Insurance Company (Stock)

Adjustments to Tax Return Data for 1982 and Projected 1983 to Conform (Approximately) with Stark-Moore Proposal (000 Omitted)

Description	1982	Projected 1983
1. Enter gain from operations before dividends and special deductions (1120L, Sch. E-2, Pt. IV, l. 3)	$ 53,799	$ 71,028
2. Enter policyholder dividends (1120L, Sch. E-2, Pt. I, l. 3)	240	--
3. Subtract line 2 from line 1	53,559	71,028
4. Enter increase in Section 818(c) amount during 1982	(3,218)	--
5. Enter 10% of cumulative Section 818(c) adjustment at beginning of year	14,125	13,803
6. Add lines 3, 4 and 5	64,466*	84,831
7. Small company adjustment (applies only if line 6 is less than $4,000,000 for company and all insurance and non-insurance affiliates, and total assets of company and such affiliates do not exceed $500,000,000)		
a. If line 6 does not exceed $1,000,000, enter 60% of line 6	-0-	-0-
b. If line 6 exceeds $1,000,000, enter $600,000 multiplied by $1 - \frac{\text{line 6} - \$1{,}000{,}000}{\$3{,}000{,}000}$	-0-	-0-
8. Subtract line 7(a) or (b) from line 6	64,466	84,831
9. Multiply line 8 by 0.75 (taxable income under Proposal)	48,350	63,623
10. Enter actual 1982 taxable income as shown on (1120L, p. 1, l. 4)	30,782	36,480
11. Enter assets as of 12-31 (per Annual Statement)	1,895,379	1,950,000

* In the case of life-life consolidation, the computation should be made in this order:

1. Enter line 6 amount for all group members
2. Make small company adjustment (if applicable)
3. Multiply the result by 0.75

STATEMENT OF MEMBER COMPANIES OF THE COMMITTEE OF ANNUITY INSURERS

As members of the Committee of Annuity Insurers, we appreciate this opportunity to advise the Select Revenue Measures Subcommittee of our deep concerns over the proposal to alter the tax treatment of annuities under the so-called "New Approach" outlined earlier this year. The Committee on Annuity Insurers, a coalition of the leading annuity writers in the United States, was formed in 1981 to monitor legislative and regulatory issues affecting the annuity industry and annuity policyholders.

I. BACKGROUND

Deferred annuities have long been used by individual consumers as a means of providing long term financial and retirement planning. Clearly, the need for such planning has heightened in recent years. As one commentator noted "[b]ecause of high prices, high taxes, and the desire to maintain a high standard of living, today more people than ever are faced with the problem of capital creation . . . to finance a livable income for their old age . . ." D. Gregg & Lucas, *Life and Health Insurance Handbook* 89 (3d ed. 1973). Moreover, the current uncertainties surrounding the viability of the Social Security system have emphasized the need for each individual to provide for retirement income. Deferred annuities consitute one method of providing for supplemental retirement income.

Deferred annuities are a well suited means of providing retirement income. The purchaser designates the commencement date for payments and thereafter, payments will continue (unless a different settlement period is selected) for the remainder of the policyholder's life. The risk that a policyholder will live beyond his life expectancy is thus borne entirely by the insurance company. Accordingly, a policyholder is assured a continual flow of retirement income for the remainder of his or her life. An annuity is therefore the most certain, convenient and complete method of providing for supplemental retirement income available to the individual today and of ensuring against the risk that the policyholder may outlive the means of his or her support.

Moreover, the annuity is not a tax avoidance device. The premiums for a nonqualified annuity are paid in after-tax dollars (i.e., such premiums are neither excludible nor deductible from gross income). Furthermore, the annuity is not tax-exempt or tax-free. All income earned on the annuity is taxed at ordinary income rates when it is received by the annuitant or beneficiary.

II. TEFRA

In enacting the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress acknowledged the beneficial role of deferred annuities in providing individuals with retirement income. As noted in the Senate Report "the Committee believes that the use of deferred annuity contracts to meet long term investment and retirement goals, such as income security, is still a worthy ideal." S. Rep. No. 97-494, 97th Cong. 2d Sess. 350 (July 12, 1982). At the same time, however, Congress sought to discourage the use of deferred annuities as a short term investment vehicle.

As a result, Congress retained the historical tax treatment of deferred annuities but adopted a number of provisions expressly designed to prevent the use of annuities as short term investments. TEFRA thus imposed a 5 percent penalty on certain "early withdrawals." The penalty is generally imposed on withdrawals of amounts, allocable to premiums paid within ten years, that are included in the policyholder's gross income. TEFRA also altered the tax treatment of early withdrawals by treating the first dollar amounts paid out as ordinary income to the extent of interest credited on the contract. Finally, Congress obviated the uncertainties at the company level surrounding the tax treatment of interest credits, by allowing insurance companies to treat all interest payments guaranteed in advance for at least a full year as a deductible expense.

These provisions have, as Congress intended, reduced or eliminated the potential use of deferred annuities as a short term investment vehicle. In fact, one recent periodical concluded that the TEFRA alterations in the tax treatment of annuities have "tended to discourage the use of tax-deferred annuities as short-term investments." Business Week, p. 9 (Dec. 27, 1982). Thus, we believe TEFRA has provided a finely crafted and workable solution that assuaged Congressional concerns that deferred annuities might be used as a short term investment vehicle, while, at the same time, preserving a valuable means for individuals to provide for their retirement income needs.

III. TAX TREATMENT OF ANNUITIES UNDER THE NEW APPROACH

It is our understanding that the Subcommittee is currently reviewing a proposal which would deny an insurance company any deduction for the amount of interest such company credits to its annuity contracts during the accumulation period. Thereafter, only a 3 percent deduction would be allowed. By disallowing a deduction for the interest credited to policyholders, insurance companies selling annuities could incur a tax liability that exceeds the amount of their real, economic pre-tax income. Implementation of these proposals, therefore, would cause insurance companies to cease selling the product and would eliminate an important retirement vehicle from the market.

As an alternative to non-deductibility of interest credits, it has been suggested that policyholders be taxed currently on interest accumulations under the contract. Under this proposal, a policyholder would either have to withdraw interest from the policy in order to offset this tax burden—thereby losing a substantial portion of the basic benefits of the annuity—or incur an ongoing negative cash flow. Thus, withdrawing money from the contract to pay taxes currently would be a significant detriment to the operation of the contract. Clearly, therefore, taxing the inside build-up would render deferred annuities far less attractive to individuals and, as a result, would severely impede and discourage individuals from engaging in long term financial and retirement planning.

IV. CONCLUSION

We believe that the changes enacted in TEFRA ensure that annuities are used for their basic purpose—a means of providing for the long term retirement needs of the American people. We therefore are opposed to the aforesaid proposal which would alter the tax treatment of annuities. We urge the Subcommittee to reject the proposal and to retain the annuity tax provisions as amended by TEFRA.

Anchor National Life Insurance Company, Phoenix, Arizona; Capital Holding Corporation, Louisville, Kentucky; Charter Insurance Group, Jacksonville, Florida; CIGNA, Philadelphia, Pennsylvania; Equitable Life Assurance Society of New York, New York; Family Life Insurance Company, Seattle, Washington; Hartford Life Insurance Company, Hartford, Connecticut; IDS Life Insurance Company, Minneapolis, Minnesota; Kemper Investors Life Insurance Company, Chicago, Illinois; Keystone Provident Life Insurance Company, Boston, Massachusetts; National Benefit Life Insurance Company, New York, New York; Northwestern National Life Insurance Company, Minneapolis, Minnesota; and Nationwide Insurance Company Columbus, Ohio.

STATEMENT OF COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers appreciates this opportunity to comment to the Select Revenue Measures Subcommittee on the Life Insurance Income Tax Proposal set forth by Congressman Pete Stark and Congressman Henson Moore ("Stark-Moore Proposal") in the Committee Print of July 14, 1983. In particular, the Committee of Annuity Insurers wishes to express its deep concerns over the major changes to the tax treatment of annuities at the policyholder level contained in the Stark-Moore Proposal. For the reasons set forth below, we believe such changes are unwarranted and unduly restrictive and, therefore, urge the Select Revenue Measures Subcommittee to ensure that such restrictions not be incorporated in any life insurance company tax measure approved by the Subcommittee.

The Committee of Annuity Insurers ("Annuity Insurers"), a coalition of the leading annuity writers in the United States, was formed in 1981 to monitor legislative and regulatory issues affecting the annuity industry and annuity policyholders. A list of the member companies of the Annuity Insurers is attached.

TEFRA AND ANNUITIES

In the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress made major changes in the tax treatment of annuities at the policyholer level. The purpose of these revisions, which were enacted on a permanent basis, was to ensure that an annuity contract is used as a long-term retirement and savings vehicle and to prevent certain perceived abuses regarding the use of annuities as short-term investment vehicles.

Specifically, in TEFRA Congress imposed a five percent penalty tax on withdrawals from the contract prior to the earlier of ten years from the investment in the contract or age 59½. The penalty tax was not, however, imposed on withdrawals paid in a series of substantially equal periodic payments over a five year period. In addition, TEFRA reversed the tax treatment of early withdrawals from the contract by treating such withdrawals as coming first from currently taxably income and then from the investment in the contract.

STARK-MOORE PROPOSAL

The Stark-Moore Proposal contains substantial alteration in the carefully crafted reforms enacted in TEFRA. The Proposal would require mandatory annuitization when the policyholder attains the age of 70½. In addition, the penalty tax provision would be altered significantly. The penalty would no longer "wear off" with respect to investment that have remained in the contract for ten years. Instead, the penalty would be applicable (with some limited exceptions) to distributions occurring anytime before the policyholder attains the age of 59½. Although the Stark-Moore Proposal would retain the exemption from the penalty tax for planned periodic payments, it would increase the period over which such payments must be made from five to ten years.

It would appear that with these changes the Stark-Moore Proposal is seeking to conform annuity contracts with Individual Retirement Accounts ("IRAs"). In attempting to equate an annuity contract to an IRA, the Stark-Moore Proposal ignores the pronounced distinctions between the two. Most importantly, such Proposal fails to take into consideration the fact that an IRA is funded with tax-free dollars while an annuity is purchased with after-tax dollars. It is to be remembered that an annuity contract is not a tax avoidance device—income will ultimately be realized by the taxpayer to the extent of the tax-deferred accumulation.

In addition, the Stark-Moore Proposal fails to take into consideration that annuities are a far more flexible means of providing supplemental retirement benefits than IRAs. Annuities can be tailored to the specific needs of policyholders, including those policyholders over 70 that need guaranteed, lifetime supplemental retirement income in order to maintain an adequate standard of living. Mandatory annuitization would deprive individuals above the age of 70½ of the most significant and flexible means of providing for such supplemental benefits for no apparent tax policy justification.

Furthermore, the five percent penalty for premature withdrawals from an annuity contract enacted by Congress in TEFRA has not been shown to be inadequate. The ten year rule on premature withdrawals is sufficiently rigorous to discourage the use of annuity contracts as short-term investments. As a result, there is simply no reason to alter these TEFRA provisions.

TAXATION OF CAPITAL GAINS UNDER VARIABLE ANNUITY CONTRACTS

Although not addressed in the Stark-Moore Proposal, the issue of the taxation of capital gains under a variable annuity contract is one which the Committee of Annuity Insurers urges the Subcommittee to carefully consider. Currently, investment earnings generated from long-term capital gains in a variable annuity contract are penalized by a corporate capital gains tax provision.

Under variable annuity contracts, the assets supporting the reserve liabilities are invested in segregated asset accounts of a life insurance company. Realized gains and losses are subject to a corporate captial gains tax (unless such assets are held for qualified pension contracts). This occurs even though those same earnings are fully taxable upon distribution at individual ordinary income tax rates. As a result, such earnings are subject to a double taxation. The Committee of Annuity Insurers recommends that the Subcommittee take action to correct this inequitable result.

CONCLUSION

The Committee of Annuity Insurers opposes the proposed changes to the tax treatment of annuities contained in the Stark-Moore Proposal. The revisions made by Congress only last year are more than sufficient to control any perceived abuses connected with deferred annuity contracts. There has been no evidence to demonstrate that any further tampering with the annuity policyholder provisions is necessary. Therefore, we urge the Subcommittee to reject these proposed changes and to permit the TEFRA rules to remain in place.

COMMITTEE OF ANNUITY INSURERS

Aetna Life and Casualty; Family Life Insurance Company; National Benefit Life Insurance Company; Equitable Life Assurance Society of the United States; CIGNA; Hartford Variable Annuity Insurance Company; IDS Life Insurance Company; Northwestern National Life Insurance Company; Kemper Investors Life Insurance

Company; National Investors Life Insurance Company; Fireman's Fund Insurance Company; Charter Insurance Group Inc.; American General Corporation; Nationwide Insurance Company; Anchor National Life Insurance Company; Keystone Provident Life Insurance Company; Capitol Holding Corporation; The Travelers Insurance Company; and National Liberty Corporation (National Home Life).

STATEMENT OF CONNECTICUT MUTUAL LIFE INSURANCE CO.

Connecticut Mutual appreciates the effort made by the Select Revenue Measures Subcommittee and its staff to remedy the inequities, inadequacies and complexities of the 1959 Act. In particular we appreciate that the approach of the Subcommittee was not directed by a search for some preconceived "segment balance". We also appreciate the attempt made to develop a single phase tax system, although as we will explain below, we fear that the Proposal in its current form does not result in a single phase system.

We do have a significant concern on the total revenue level sought from the industry as a whole and the portion that mutual companies would pay under the Proposal. The total revenue level sought is excessive and could significantly restrict the ability of the insurance industry to compete with other financial institutions. We are equally concerned that the apparently unintended effect of the Proposal imposes on the mutual segment of the industry a tax burden even larger than the '59 Act would impose. Such a burden would seriously impair our competitiveness both within and without the industry.

We have set forth below our major concerns and, where possible, proposed changes that we believe would be necessary to remedy the perceived defects. Following these concerns we have briefly listed several other areas in need of further study or attention.

MAJOR AREAS OF CONCERN

A. Ownership differential

It will come as no surprise that the most troublesome feature of the Proposal is that element that flies under the banner of an "ownership differential". Totally aside from the fact that we do not believe that any differential (additional burden) on mutual companies is in the public interest, the specific formula proposed radically departs from the concept of taxing economic income and the manner in which it applies contradicts the espousal of a single phase tax.

When Congress enacted the "Stopgap" provisions of TEFRA, it implicitly recognized the industry's overwhelming need for tax relief. Not only had the industry's aggregate tax burden risen disproportionately since the enactment of the inherently flawed '59 law, but companies like Connecticut Mutual, who have concentrated on providing basic insurance coverage to the American public, were particularly disadvantaged by the inherent defects in the '59 law. Yet, initially, in 1959, our company was able to deduct approximately 90 percent of its dividends paid but by 1979 the deductible percentage had been reduced to approximately 58 percent. Despite the burdensome tax levels of the '59 Act, under Proposal, using 1982 as a base year, Connecticut Mutual will have a tax burden in excess of the '59 Act tax by an additional 20 percent. We believe that the tax burden under TEFRA represents a fair level of tax for the industry under current economic conditions. Needless to say, the Proposal's tax burden far exceeds that level. Furthermore, the comparative difference between our company and most stock companies would appear to widen as time passes. We do not believe that the drafters of the Proposal had any appreciation that this would be the result.

Aside from the inherent invalidity of any differential, the specific treatment in the Proposal appears to assume that the "ownership" interest of a mutual policyholder is virtually identical to the ownership interest of the stockholder. This is, we believe untrue and ignores major differences between the two "ownership" rights. The differences are fundamental and deserve markedly different treatment even if some ownership interest is to be recognized. First of all, not only does the policyholder not consider himself an investor, he does not, at the time of his contractual undertaking, make any investment or provide the company with capital. Indeed, if the individual were to promptly terminate his relationship with the company through lapsing the policy, the company would be left with a loss as distinguished from being left with forfeited capital contributions. Furthermore, even if the initial policyholder is deemed to have acquired some interest in the existing accumulation of surplus, the policyholder has absolutely no access to that interest unlike that which the marketplace provides to an investor and the right to some pro-rata return upon liquidation is not only extremely small but lacks economic reality as well. Consequently, it is totally inappropriate to treat a mutual policyholder on any parallel with a stockholder. Yet, this is essentially what the Proposal seems to do.

Even if we were to assume that there is some theoretical basis for a return on equity approach, it should be clear that fundamental and major changes would have to be made to make this proposal viable. An appreciation for the lack of comparability between the mutual policyholder's interests in a corporation and a stockholder's dictates that the measurement of the equity base (surplus) and the deemed rate of return on that surplus must be changed.

Considering the nature of the mutual policyholder's interest in the corporation, the annual statement surplus is a far more appropriate measure of this aggregate equity than is contained in the Proposal. Certainly, the inclusion in "surplus" of the unmistakable liability represented by dividends payable in the following year (in some cases, only a short time after the dividend declaration) is inappropriate. In addition, given the admitted difficulty of even measuring the ownership interest of a mutual policyholder in the first place, the attempt at precision by the further inclusion of the mandatory securities valuation reserve and adding back non-admitted assets belies this difficulty and is inconsistent with the substantially different nature of the policyholder's and shareholder's interests. The combination of the admitted difficulty in making any precise measurement in the first place coupled with the lack of comparability of the different ownership interests dictates a conservative approach to the measurement process.

More importantly, however, the inclusion in the formula of any deemed or external return on this reconstructed equity lacks any economic realism. To ask the taxpayer to base his tax on what someone else may have earned is totally inconsistent with an attempt to tax economic income. Any rate that is to be employed should relate to the actual earnings of the taxpayer in question and not some outside benchmark. Additionally, the rate should reflect the actual earnings on surplus which should be the portfolio rate actually earned by the taxpayer, not "grossed up" artificially based upon the invalid assumption of comparability with the ownership interest of a stockholder.

Changes such as these in both the equity base and rate of return would produce far more equitable recognition of the policyholder's so-called "equity interest" despite the unavoidable and inherent weakness of the concept. Even if a theoretical argument could be made that the proposed concept is appropriate, we believe it would be premature to adopt any particular approach for recognizing an ownership differential until all other possibilities have been fully explored. While it might turn out that this approach is the best of the poor surrogates for converting a policyholder to a stockholder, other approaches may be more practical. One such approach is the possibility of establishing a particular dividend differential not dissimilar to that contained in Stopgap. Such a proposal and its effects might be more easily identified in terms of product competitiveness in the marketplace in the event that market neutrality is not achieved. Furthermore, such an approach could be combined with some truly minimum tax to assuage the fears of those who believe that dividend differential alone might be circumvented by imprudent distributions of surplus or "dividending-out". Indeed, perhaps some modest "surplus-interest" approach could produce this minimum, but a variety of other approaches could be constructed to serve this purpose as well.

A further defect in the ownership differential portion of the Proposal, although unintended, is that it causes a return to a multiple phase tax system. While all stock companies would only be taxed on their gain from operations after dividends, most mutual companies (including Connecticut Mutual) would be taxed on the minimum tax base. However, some mutual companies could instead either be taxed on their gain from operations after dividends or their gain from operations before dividends. Thus, mutual companies could be taxed under multiple phases while the stocks would only be taxed under a single phase. Since multiple phase systems do not effectively tax economic income, mutual companies would again be subject to one of the defects of the 1959 Act.

Finally, we are convinced that the magnitude of the current differential allows stock companies to get a full deduction for all payments to customers while the exact equivalent payment to a mutual policyholder is partially categorized as an "ownership" return. Mutual companies should be able to get "customer" treatment for payments to policyholders to the exact same extent that stock companies do. If any "ownership differential" is to be imposed it should only apply to additional payments to mutual policyholders that exceed the full equivalent of amounts paid to stock company policyholders.

B. The treatment of stock subsidiaries

In determining the income of a stock subsidiary—and consequently, the tax that should be paid by that subsidiary—all payments to policyholders should be treated identically with comparable payments made to "stock" company customers. A policyholder of a stock subsidiary is only a customer and has absolutely no other interest in the corporation. Consistent with the fiduciary obligation the stock subsidiary has to its shareholders (and in turn the obligation the mutual parent has to its owners) no payment to the customer can in any respect be considered an equity return. The customer of the stock subsidiary has neither a real or theoretical ownership interest in the corporation. Consequently, the taxation of the stock subsidiary of a mutual company should be identical with that of any stock life insurance company.

Mutual companies have been tax disadvantaged for many years. We can see a real prospect for the tax disadvantage being continued even though perhaps unintentionally. Nothing in the current proposal would dissuade an impartial observer from the realism of that concern. It should be fairly obvious that it would be much easier from an administrative and regulatory perspective for a mutual company to conduct its business solely at the parent level as it has traditionally done. Indeed, we believe virtually every mutual insurance company would make that choice because of the inherent simplicity if it were not for the potential tax disadvantage. The rush of mutual companies to either establish or acquire stock subsidiaries arises from this fear. Whether this is paranoia or simply good judgment, may well depend simply upon the outcome of the current deliberations. The mutual industry's only objective is to have a "safety value" so that it can compete in the marketplace in the event that its worst fears are realized and tax laws have again put it at an intolerable disadvantage. Mutual companies are not seeking the lowest of two possible taxes but simply need a vehicle which will prevent them from becoming the dinosaurs of the insurance industry.

C. Treatment of reserves

We oppose the application of state law minimums for all policies. Those minimums would create problems for nonindividual and non-cash value policies, e.g. group annuities, substandard liabilities, disability income benefits, etc. Further study is needed to determine the treatment appropriate for these types of reserves. For individual cash value life insurance, we support the use of CRVM with a cash value floor.

There should be no additional income created for mutual companies from any reserve run-off to the extent that such reserve produced no tax benefit. In particular, the Section 818(c) reserves created prior to stopgap created a minor tax benefit for mutual companies yet those reserves will produce fully taxable income to us when the applicable business runs off our books. An adjustment should be made to whatever tax base is developed under permanent law so that the tax created from the reserve run-off does not exceed the previous tax benefit received.

D. Policy loans

We oppose any changes which would limit deductions for interest paid on loans from life insurance policies. Such a change is not needed since existing Section 264 and the proposed tightened definition of life insurance should prevent abuses in this area. Any abuses not eliminated by these changes should be dealt with specifically without "throwing the baby out with the bathwater". Also, such a limitation is inconsistent with general tax philosophy which allows a person to borrow against other personal assets (e.g. a residence) and deduct the interest without limit. To carve out a special limitation for a particular type of property (further limited to only loans of a particular size) unfairly discriminates against this type of property. Furthermore, a significant number of policyholders would simply borrow from other lenders against the security of the policy which would circumvent the purpose of the proposal however ill conceived it might be.

This proposed change would have an adverse financial impact on companies since it could cause a premature lapse if a person could not borrow as initially contemplated. In addition, it would have a significant financial impact on most mutual companies since their traditional premium policies would be disadvantaged in comparison with many non-traditional policies which allow partial withdrawals in lieu of policy loans as a mechanism for accessing policy values.

E. Taxable income adjustment

The 25 percent taxable income adjustment does not represent sound tax policy since it is an artifical deduction used to attempt to derive a tax based on economic income. A true tax based on economic income does not need such a reduction device.

Also, the existing application of this adjustment to stock companies appears to have the effect of preserving the various special tax benefits they received under the 1959 Act. Our position is that we can no longer exist with a competitive disadvantage created by such special tax benefits.

OTHER AREAS OF CONCERN

A. Qualified pension business

The provisions of TEFRA granted all insurance companies a full deduction for dividends attributable to insured qualified pension plans. Those provisions carried out Congressional intent that income attributable to insured pension plans would be tax-free so that the insurance industry could effectively compete for qualified pension plan business. The Proposal does not carry out that Congressional intent for mutual companies since under its provisons we would not effectively get a full deduction for dividends credited to qualified pension plans. Unless appropriate adjustments are made to the Proposal to remedy this defect our ability to compete in this marketplace with stock life insurers and other financial institutions will be seriously impaired which is not in the public interest.

B. Computation of investment in the contract

We oppose this change since there are no justifiable reasons for it. Although gain on personal assets is taxable, adjustments are not made to the basis of other personal assets to compute gain (e.g. on personal residence). This proposed change has an increased adverse effect since it has greater application to older people due to larger term cost charges. Also, this change will cause compliance problems for insurance companies which are unwarranted.

C. Tax exempt income

The Proposal essentially denies mutual insurance companies any credit or benefit for tax exempt income despite its stated objective of continuing the present law treatment concerning such income. We believe that any permanent legislation should change the present rule and the existing Proposal to provide that all insurance companies would get the full benefit of tax exempt income without adjustment because of the proration rules.

D. Definition of life insurance

We support the definition of life insurance as set forth in the Proposal. There was a need to tighten that definition in order to prevent abusive products which masquerade as life insurance products. These products do not contain significant insurance elements and thus should not qualify as life insurance.

CONCLUSION

We again would like to express our appreciation for the efforts of the subcommittee and its staff in attempting to replace the 1959 act with a simplified single phase tax not motivated by pre-conceived notions as to "segment balance" between mutual and stock companies. The work to date represents significant progress towards a permanent solution which will eliminate many of the flaws under the '59 Act. However, there are some major problems with the proposal which require further attention. The major areas of concern are:

The treatment of the "ownership differential" and the burden imposed on mutual companies;

The treatment of stock subsidiaries of mutual companies and the need for a marketplace safety valve;

The discriminatory treatment proposed for loans on life insurance policies, and

The need for relief from taxable income resulting from the 818(c) reserve run-off in excess of previously received tax benefits.

The effective date provisions in the Proposal are in need of revision. We urge that these provisions grant our requested relief from the Section 818(c) run-off for tax years beginning in 1982.

Finally, while we recognize that time is short, we do not believe that conceptual decisions can be made within the time frame that we understand has been proposed by the subcommittee. In several of these major areas it will be important to fully explore various alternatives in seeking the soundest conclusions. It would be unfortunate if premature decisions were made in important areas which in hindsight may prove to be unworkable. We would urge that no decisions be made until more time has been afforded all concerned to more fully evaluated the proposal and possible alternatives.

FAMILY LIFE INSURANCE CO.,
Seattle, Wash., April 29, 1983.

COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Longworth Building, Washington, D.C.

GENTLEMEN: We request that this letter be made a part of the printed record of the Subcommittee Hearings on the Taxation of Life Insurance to be held on May 10 and 11, 1983.

Family Life Insurance Company's position in the life insurance industry is perhaps unique in that, for a period of more than 30 years, Family Life has specialized in writing decreasing term life insurance—insurance which produces no "inside build-up." Of $8 billion of insurance in force, less than 0.2 percent is insurance producing cash values. Thus, in theory at least, a proposal to tax the inside build-up of life insurance by levying a "proxy tax" against the insurance company should have minimal impact on Family Life.

The "new approach" presented to the Subcommittee on April 7, however, would have increased Family Life's income taxes by approximately 76 percent for 1981 and 45 percent ofr 1982! Clearly, the "new approach" has some flaws as a proxy tax on the inside build-up.

Family Life Insurance Company believes that a new approach to life insurance taxation is not necessary. The 1959 Act functioned well until the recent period of high inflation and volatile interest rates. While the 1959 Act may be in need of repair, it is not necessary that it be scrapped. A new tax vehicle with an aerodynamic exterior, but untested mechanics, can lead to years of uncertainty while all the "bugs" are worked out. Most of the "bugs" in the 1959 Act have been eliminated over the years by judicial decisions and rulings of the Internal Revenue Service. Fundamentally, it is a reliable and dependable tax vehicle, but in need of a tune-up.

Sincerely,

D. MCKAY SNOW,
Secretary and Counsel.

W. V. HARRIS AGENCY, INC.,
MANAGING GENERAL AGENTS,
Newtown, Conn., July 26, 1983.

HOUSE OF REPRESENTATIVES,
Washington, D.C.

DEAR GENTLEMEN: It has been called to my attention that consideration is being given to a maximum annuity commencement age of 70.5 for the non-qualifed annuity. I urge you to reconsider since the non-qualified annuity is primarily being used as a retirement supplement to the IRA and pension programs as a hedge against inflation.

Unfortunately, the monthly benefits that participants will receive from his or her IRA and/or pension plan will be eroded by inflation. For example, in ten short years a retiree's benefits would be worth $.50 on every dollar assuming 5 percent inflation. We need a tax-advantaged program that will accumulate to the greatest extent possible with 100 percent safety. the non-qualifed single premium deferred annuity fulfills these objectives. Shortening the annuity commencement date to 70.5 places a cap on the accumulation phase of the annuity and limits the flexibility extensively.

In my opinion, we wish our taxpayers to have less dependence on the Social Security system and shift a greater degree of responsibility back to them. However, we must provide them the necessary tax-advantaged programs to assure a comfortable retirement in spite of inflation.

Sincerely,

W. V. HARRIS.

JEFFERSON-PILOT CORP.,
Greensboro, N.C., May 18, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN STARK: For your Subcommittee's consideration in developing permanent income tax provisions for life insurance companies, we would like to bring to your attention a major problem under present law in determining the foreign tax credit for U. S. life insurance companies. We have noted with interest that this matter is specifically addressed at pages 57 and 58 of the May 5, 1983 Hearing Pamphlet prepared by the Staff of the Joint Committee on Taxation to provide background for your Subcommittee's hearings on the taxation of life insurance companies.

Our life insurance subsidiaries, Jefferson Standard Life Insurance Company and Pilot Life Insurance Company, have for many years been among the largest U. S. writers of life insurance in Puerto Rico. As such, our annual tax burden in Puerto Rico is substantial. Puerto Rico's general income tax laws are patterned after the U. S. Internal Revenue Code of 1939. Since 1974, however, Puerto Rico has imposed an income tax on U. S. life insurance companies based on the percentage of U. S. taxable income that is allocated to Puerto Rico (i.e., a "piggy-back" tax). The starting point for the allocation formula is U. S. taxable income, as reported to the IRS on the 1120L tax return. Therefore, the Puerto Rican tax base places the same emphasis on the taxable investment income and the gain from operations as the Internal Revenue Code. The second step in the allocation formula determines the ratio of direct premiums from Puerto Rico over worldwide direct premiums. If 2 percent of the net premiums are from Puerto Rico, 2 percent of U. S. taxable income is allocated to Puerto Rico. By this system of taxation, Puerto Rico is able to collect an appropriate share of tax relative to the insurance business conducted in the Commonwealth. On aggregate Puerto Rican premium receipts of $8,863,650 in 1981, we paid $641,024 in income tax to Puerto Rico. This was 1.7 percent of our 1981 U. S. income tax liability.

The major problem with present law is that the Internal Revenue Code does not provide rules for determining the source of a life insurance company's underwriting income and investment income associated with foreign insurance risks. Although I.R.C. §§ 861–863 do provide source rules of general applicability, the history of the life insurance company income tax provisions suggests that these rules were not intended to apply to life companies. This is because application of these rules would result in distortions in tax liability from a mismatching of the sources of underwriting income and investment income related to the same insurance risks. For example, investment income generated in the U. S. may directly relate to underwriting income and reserves associated with foreign insurance risks.

The Hearing Pamphlet alludes to these distortions by pointing out that if present law requires that the foreign tax credit be computed by determining foreign source income on a phase-by-phase basis (taking into account the general source rules), a U. S. company paying relatively high foreign income taxes would have an incentive to invest its assets abroad rather than in the U. S. By increasing its foreign investments, a U. S. life insurance company could guarantee that all foreign taxes it pays, not matter how large, are creditable against U. S. tax. Conversely, a U. S. company that invests all its assets in the U. S. could pay a tax penalty by losing its ability to credit foreign taxes.

We agree with the Joint Committee Staff that the foreign tax credit and related source rules should be clarified to eliminate the necessity that a U. S. life insurance company invest a portion of its assets abroad. In fashioning a legislative solution, we urge your Subcommittee to consider a retroactive remedy of this serious case of double taxation between the U. S. and Puerto Rico. The use of the phase-by-phase approach by the IRS imposes a penalty on companies, such as ours, that invest assets in the U. S. Retroactive relief seems particularly appropriate because the Puerto Rican tax system is based on bottom-line taxable income and not the exact source of the investing or underwriting income.

Although the corporate tax rate imposed by Puerto Rico is lower than the corresponding U.S. rate and is based directly on the portion of the U.S. tax base attributable to Puerto Rican business, a phase-by-phase application of the source rules of §§ 861–863 could make a significant portion of the Puerto Rican taxes paid by our companies non-creditable. This occurs solely because of a tax penalty under the phase-by-phase approach for investing our assets related to Puerto Rican insurance risks in the U.S.

Double taxation through denial of a foreign tax credit is intolerable in these circumstances in view of the close fiscal cooperation between Puerto Rico and the U.S. and the similarity of our income tax laws. Since Puerto Rico bases its income tax on a portion of the life insurance company taxable income determined under U.S. law at a tax rate lower than the U.S. rate, it is apparent that this double taxation is caused essentially by the distortions in applying the phase-by-phase approach referred to in the Hearing Pamphlet rather than in applying Puerto Rican law.

If the Internal Revenue Service applies the phase-by-phase approach to our companies for past years, we would be forced to seek relief from this double taxation either through litigation or through negotiations among our companies and the international tax authorities of the U.S. and Puerto Rico under the U.S.-Puerto Rico Agreement on Coordination of Tax Administration. The U.S.-Puerto Rico Agreement includes a procedure to resolve cases of double taxation. Rather than have this important question addressed in this ad hoc manner with our companies possible caught in the center of intra-government tax negotiations, we urge your Subcommittee to clarify present law to provide appropriate relief. Specifically, we request that any legislation designed to eliminate the necessity that U.S. life insurance companies invest abroad, also include a provision that clarifies for past years that the income taxes paid by U.S. life insurance companies to Puerto Rico are fully creditable against U.S. income tax.

We believe that what we are suggesting is in complete harmony with the policy underlying both the foreign tax credit and U.S.-Puerto Rico income tax relations.

Please include this letter in the printed record of the hearings held by your Subcommittee on May 10 and 11, 1983.

Sincerely yours,

W. ROGER SOLES.

JEFFERSON-PILOT CORP.,
Greensboro, N.C., July 25, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN STARK: I would like to congratulate you and Representative Moore for developing a proposal which, in my opinion, can serve as the framework for a permanent method of taxing life insurance companies and their products.

Jefferson Standard Life Insurance Company and Pilot Life Insurance Company, the two life insurance companies owned by Jefferson-Pilot Corporation, have over the years paid substantial amounts of Federal income taxes.

In fact in 1981 our life insurance companies paid an effective tax rate of 37 percent and together constitute the second largest Federal income tax payor in North Carolina. To further illustrate this point, in 1982 our life insurance companies paid 2.3 percent of the total Federal income taxes paid by all United States life insurance companies even though our assets amounted to only 0.5 percent of total industry assets and our premium income to only 0.6 percent of total industry premium income. Life insurance in force amounted to only 0.7 percent of the total amount.

As we participated in industry efforts to develop an acceptable tax bill we soon discovered that many life insurance companies actually paid little or no Federal income taxes even though substantial amounts of economic income were being produced. We believe that this is unfair and has caused Federal income taxes to be the major factor in determining market share for sales for life insurance companies. To me among the most important tasks to be performed by your Subcommittee is to make certain that the life insurance industry pays its "fair share" of taxes, but no more, and that all companies which have earnings participate in that tax obligation.

The basic framework of your proposal is a substantial step towards simplification. The method of imputing an equity return to mutual life insurance companies is the key to simplification, and it represents a significant accomplishment by the Subcommittee. The imputed return on equity is a fairer mechanism to establish balance between stock and mutual life companies than the phase system of the 1959 Act. By substituting an ownership differential for limiting the deductibility of policyholder dividends for the current taxable investment income limitation, it is possible to allow all companies to deduct all amounts paid or credited to policyholders in their capacity, "as customers." The new methods for establishing segment balance will end the unnecessary and inequitable limitation on the deductibility of dividends imposed by the three phase tax system. Of major concerns, however, is that your Committee will be pressured to reduce the suggested imputed return on equity rate of 23 percent.as well as the method of determining the amount of equity. We hope that you will resist those efforts.

The proposed one phase tax system will promote competition within the industry by ending the current stituation where certain products can only be competitively priced by companies in certain tax positions. The one phase tax system will also eliminate the motivation for certain companies to devise strategies intended to shift income from one tax phase to another in an effort to reduce or avoid taxes.

The proposed limitation on policy loan interest deductibility is clearly directed at eliminating abusive policy loan arrangements. We believe that your approach is a satisfactory one that will enable policyholders to borrow against a valuable asset when they have a special need.

I know that your Subcommittee will receive many and varying comments at the hearing scheduled for July 28, and that your tasks of refining those comments into the Subcommittee's proposal for a permanent tax package will be difficult. Although I could list numerous changes which I would like to see made, I will confine my comments to the following major items of concern:

1. We commend your efforts to find a sound basis for determining life insurance reserves for income tax purposes. The proposed restatement of reserves, as of January 1, 1984, to the level as recommended by the Stock Information Group appears to be the most promising solution to a difficult problem. The computation of tax reserves is an essential part of the determination of the equity of mutual life insurance companies.

We, however, object to the proposed transition rule that would require each company to recapture as income, over ten years, the decrease caused by the difference between the reserves computed under the present rules and the reserves computed under any new rule which may be adopted. We believe that any recapture requirement will be unnecessarily harsh and inequitable for serveral reasons. First, the proposed framework for taxing life insurance companies involves totally new concepts. Because of these substantial changes, we believe that a "fresh start", independent of past tax law, is appropriate. We are not aware of any other industry that has been required, as part of major revision of their tax structure, to recapture as income those items that have been treated as appropriate deductions for approximately 24 years. Second, recapture would increase our already heavy tax burden by approximately $1,000,000 a year. Third, your proposal imposes a disproportionate tax burden on companies, like ours whose tax base for nearly all of the years involved was taxable investment income and therefore we received a tax benefit that was far less than the tax that would be imposed by the proposal to tax the January 1, 1984 difference in reserves.

2. We are uncertain of the meaning of the proposed change in the rules that prorate tax-exempt interest and dividend income but feel that it will have a substantial adverse impact on our companies. It the proration concept is expanded beyond present law, it will be totally inappropriate for most life insurance companies to hold any tax-exempt bonds. This change could have significant impact on the tax-exempt bond market, and the ability of state and local governments to raise necessary funds. Life insurance companies will not be able to compete with other financial institutions which are permitted to totally exclude tax-exempt income, and to claim the 85 percent dividend received deduction.

3. The definition of life insurance is a complex issue that is of great importance to our companies. It is our opinion that the guideline premium and cash value tests proposed by the Stock Company Information Group would be an adequate restraint on policies that are overly investment oriented. Your proposal, however, will prevent the typical life insurance policyholder from consolidating several existing policies into one of the new universal life type products. Instead of continuing his or her investment in life insurance, your proposal will encourage the removal of cash value for other purposes. We ask that your Committee reconsider the proposal and eliminate the 10-pay life rule for either test and the expansion of the "corridor" percentage beyond those found in TEFRA.

4. The proposal suggests four options for dealing with the policyholder surplus accounts. We believe that the major revisions being made in the taxation of life insurance companies, which according to the Subcommittee's estimation will produce substantial increases in revenues, calls for a fresh start. Therefore, the most equitable approach would be to impose no tax on those accounts. Any requirement that companies bring the amount in the policyholder surplus account into income will cause subetantial increases in income tax liabilities thereby placing our companies at a serious competitive disadvantage. In fact, requiring these amounts to be included in our income will increase our tax by $3,860,000 each year even though no payments from these amounts will have been made to our stockholders. The mutual

companies have been able to avoid the potential phase three tax because they were permitted to reduce their gain from operations by increasing dividends to their owners/policyholders.

The Subcommittee staff indicated that the proposed tax system should produce $4.7 billion in revenue in 1984. This represents a significant increase over the ACLI estimate of $2.1 billion if TEFRA is extended for one year, or the $3.6 billion of revenue that would be produced if the tax law reverts to the 1959 Act without modified co-insurance. Although the life insurance industry is basically strong and healthy, it is facing increased competition from other financial institutions. We are concerned that a substantial increase in our relative tax burden, when competing institutions continue to pay a reduced amount of taxes, will lessen our ability to compete in a progressively deregulated market for financial services.

In summary, we would endorse a permanent tax bill based upon the general framework of your proposal, as amended to:

1. Not require any recapture of reserves due to any change in the method of computing reserves;
2. Not require an expansion of the proration concept by including all amounts paid or credited to policyholders in the policyholders' share of investment income;
3. Adopt the Stock Company Information Group proposed definition of life insurance; and
4. Impose no tax on the present Phase III accounts.

We believe that a bill based upon your proposal with the above mentioned changes will be fair and equitable to all segments of the life insurance industry, will allow a smoother transition to a new tax system, and will produce an equitable amount of revenue from both segments of the industry.

Sincerely yours,

W. Roger Soles.

John Hancock Mutual Life Insurance Co.,
Boston, Mass., July 28, 1983.

John J. Salmon,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

Dear Mr. Salmon: We wish to emphasize further one point made in the statement submitted to the record on behalf of the John Hancock and several other mutual companies.

Stock subsidiaries of mutual companies should be treated as stock companies, not as mutual companies.

It is hard to understand why a stock life insurance company owned by a mutual life insurance company is to be taxed as if it were a mutual company, and yet a stock life insurance company owned by any other type of corporation, such as an industrial or financial conglomerate, would be taxed as a stock life company.

Purchasers of policies from our stock life subsidiary have no ownership interest in that company; they do not perceive themselves as owners, nor are they such, as a matter of law. All benefits of ownership accrue to the parent corporation, as a stockholder; whatever economic return might arise belongs to that parent.

The investment made by the John Hancock in its stock life susidiary is like all other investments made by the John Hancock, in the sense that it expects to realize a return on the investment. The Mission Statement of the John Hancock makes it clear that the earnings of all its subsidiaries are intended to benefit the participating policyholders of the parent mutual company.

Another reason that makes this matter important is that the whole concept of the "ownership differential" is controversial as to both theory and amount. Any differential arrived at through the political process carries little if any guarantee of precision. To the extent that the differential proves to be too large, it will impact most heavily on those types of products which are most sensitive to expense levels (including taxes on the issuing company). In these areas only a stock company could offer a competitive product. If mutual companies are to be able to compete in these markets, they will have to do so through stock subsidiaries. If their stock subsidiaries are taxed as mutuals, the higher tax burden imposed by the "ownership differential" will exclude mutuals and their subsidiaries from these markets and make these products less competitive overall.

Thank you for allowing us to add this point to the record of the hearing.

Very truly yours,

E. JAMES MORTON,
President and Chief Operations Officer.

KEYSTONE PROVIDENT LIFE INSURANCE CO.,
Boston, Mass., July 22, 1983.

Re life insurance income tax proposal.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: The proposed definition of life insurance poses serious concern for individual life insurance companies who would ultimately be affected.

The proposed change in definition has the effect of:

Limiting the ability of the industry to develop the products necessary to meet consumers' unique insurance needs;

Limiting the flexibility of the buyer to revise insurance amounts and premium patterns as needs change.

In particular, the substitution of "10 Pay Life" rules for the Single Premium rules of TEFRA has negative consequences:

It destroys much of the flexibility of Universal Life products as to how premiums are paid;

It creates substantial technical and administrative recordkeeping burdens when flexible products are employed. For example, if a change were made annually, The guideline premium limit could consist of as many as eleven parts, all of which would have to be individually monitored. Small stock companies would be priced out of the market;

The proposal is in direct conflict with state laws which require a reduced paid-up Nonforfeiture benefit;

The proposal grants a special exception to mutual companies by exempting paid-up dividend additions. Such an exception obviously creates a competitive disadvantage for stock companies. Moreover, the need for major exceptions points out the weakness of the concept.

The goal of a definition should be to put some restraints on what is life insurance, not to reduce the choices of consumers as to what they will buy and how they will pay for it. Should this proposal stand, it is likely that one side of the industry, mainly stocks, will see declining sales. Not only would this create an unlevel playing field, but it would also produce less tax revenue.

In conclusion, all evidence seems to show that the TEFRA regulations have worked out well for Universal Life. Thus, there is little reason to experiment with untried modifications in permanent legislation. Logic dictates that the simplest and best approach would be to extend the TEFRA definition to all products in the most direct possible manner.

Sincerely,

ROBERT G. SHARP.

STATEMENT OF MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

I. OVERVIEW

One goal which we seek in revising the company federal income tax law is that it be based on sound tax principles. Our experience under the 1959 Act convinced us that this is an absolute necessity. It is evident from the provisions included in the proposal that the Subcommittee shares this goal. We are particularly pleased that the Subcommittee chose to pursue a simple single phase tax structure under which all items of revenue and deduction would be treated similarly for all life insurance companies. We hope that the Subcommittee will continue to apply sound tax principles in the company federal tax bill which it develops.

Another goal which we seek in revising the company federal tax law is simplicity. We seek this because of the many problems we encountered in interpreting and applying the 1959 Act. We also seek to be taxed comparably to other corporations so that we can compete with them. We believe the Subcommittee's proposal represents a major step toward this goal. As we discuss later, however, this goal has not been met entirely. For example we would be subject to different rules with respect to taxation of some of our investments. This adverse result may be unintended and we hope that it will be corrected in developing a company federal tax bill.

Most important, in developing a new company federal tax law, we seek to have the law based on taxation of our company's economic income. Unfortunately, while the Subcommittee also seems to seek this goal, the proposal falls far short of it. In fact the tax base for mutual companies set forth in the proposal strays further from economic income than "taxable investment income," which was the mutual company tax base under the 1959 Act. It is hard to believe that this is the result intended by the Subcommittee. If the rates and definitions in the proposal are changed, it is possible that the proposal would be acceptable.

A minimum tax to control "dividending-out" is acceptable but a so-called minimum tax which is in fact the only tax for a mutual company is unacceptable and we hope unintentional. Under the proposal, nearly all mutual companies would be taxed solely on the minimum tax base. In this regard the Subcommittee's proposal fails to reflect the sound principle that tax should be based economic income. We believe the concepts and mechanisms set forth in the Subcommittee's proposal are sound and useful. We hope the Subcommittee will change the proposal so that it is responsive to economic realities. This is essential to achieve product equity so that we can compete with others on an equal footing in the market place.

II. COMPANY TAX ISSUES

A. Ownership differential

The proposal calls for recognition of an ownership differential through imposition of a limitation on the deductibility of policyholder dividends. We accept this as a satisfactory method for recognition of the fact that the policyholders own a mutual life insurance company.

The proposal also provides for determination of the amount of the ownership differential by imposition of a company level tax on the earnings on the policyholders equity in the company. We accept this as one satisfactory method for measurement of the amount of ownership differential. A variation of this method, discussed later, directly limiting deductibility of policyholder dividends may be preferable.

While we can accept the strucuture in the proposal for determination and assessment of the ownership differential, we strongly oppose some of the specific approaches which have been used in implementing this structure.

1. Determination of equity

We agree that the equity of a mutual life insurance company should be determined by reference to the excess of assets over liabilities as shown on the company's annual statement required under state law. We do not, however, agree with all of the adjustments which it is suggested in the proposal should be made in determining the policyholders equity. Specifically:

(a) We agree that it is appropriate to limit the amount of the reserves used in calculating the policyholders equity to the amount used in determining the company's gain from operations for federal tax purposes. Otherwise there would be a fundamental inconsistency with respect to the reserve attributed to the same contract when making different tax calculations.

(b) We object to inclusion of the MSVR in determining the policyholder equity in a mutual company. State regulations require that this adjustment be made in order to avoid overstatement of the net worth of a life insurance company. The MSVR corrects a potential overstatement in the value of company assets and results in a more accurate statement of net worth. In view of this, it is fundamentally wrong to include the MSVR in the equity of a mutual life insurance company.

(c) We object to the proposal that policyholder dividends which have been declared should not be recognized as a liability in determining the policyholders equity in a mutual company. When a dividend is declared, it is a liability of the company and should be recognized fully as such in determining the policyholders equity in the company. This treatment would accord with both statutory and GAAP accounting practices.

(d) We believe it is improper to include most non-admitted investment assets in the determination of the amount of the policyholders equity. These assets are deemed worthless and have been written off as assets of the company. In view of this, it is not sound to include these assets in calculating the equity of the company. On the other hand, assets not admitted because of state investment diversification requirements are properly part of surplus.

2. Determination of rate of return

We do not agree with the proposal regarding the determination of the rate of return to be applied to the policyholders equity in measuring the amount of the ownership differential. We believe that the method chosen leads to an excessive and unrealistic rate.

We see no reason to relate our equity return to that obtained by the companies in the S&P 400 Index. The result of such a comparison is irrelevant to the determination of the rate of return achieved by a mutual life insurance company because the nature of the business done by the country's leading industrial concerns is far different than that done by a mutual life insurer.

We also see no justification for using the rate on one-year Treasury bills (grossed up by the corporate tax rate) in determining the rate of return of a mutual life insurer. This rate, standing alone, does not reflect the result of the investments made by the mutual company or of any other activity of the company. It also would be improper to gross up the rate by the full corporate tax rate when stock companies pay an efective tax rate which is considerably less.

We do agree that it may be appropriate to consider the rate of return achieved by stock life insurance companies in determining the rate of return of a mutual company although it should be recognized that the comparison may be invalid because the nature of the business written by the stock companies may be different from the mix of business written by mutual companies. Specifically, high-profit blocks of nonpar business held by stock companies raise their earnings rates substantially. Mutual companies have no such business.

While comparison to the rate of return achieved by stock companies may be an acceptable approach, if for no other reason than that it is a comparison to others doing an insurance business, the best approach would seem to be to use the mutual company's own portfolio rate. This has the advantage of relating the rate of return to the company's own experience. It may be necessary to adjust this rate to eliminate the depressive effect of policy loans. This would give a realistic earnings rate.

We want to emphasize that the rate of return set initially in the proposal at 23 percent is extraordinarily excessive. It means that many, if not all, mutual companies will pay the minimum tax and not be taxed on their gain from operations. This is substantially what happened under the 1959 Act and is the result which we were trying to avoid by asking that the new permanent company federal tax be based on sound tax principles. The proposal is contrary to sound tax policy because under it part of the industry would be taxed on gain from operations and the rest of the industry would be taxed on imputed earnings on policyholders equity. Further a rate above 20 percent creates a substantial inducement to companies to reduce their surplus. This is poor public policy and could lead to insolvencies unless corrected.

The result will vary from company to company, but the minimum tax level contemplated in the proposal will lead to over a 60 percent disallowance of dividend deduction at Massachusetts Mutual. This is an unreasonable differential level and will lead to serious competitive distortions. Bluntly, the differential in the proposal will drive mutuals out of the market—a great disservice to the consumer and the economy.

The impact of the ownership differential on the tax liability of Massachusetts Mutual is dramatic. Under it, in 1984 Massachusetts Mututal would pay federal income tax of $143 million. If we were taxed as a stock company, however, our tax liability would be only $49 million. This difference is in fact even greater because approximately $21 million of the stock company tax results from the run-off over ten years of reserves which would no longer be allowed. Thus, the long-term impact of the proposal would be a tax of about $28 million if we were a stock company compared to a tax of about $143 million if we were taxed as a mutual company. This means a tax five times as great for a mutual as for an identical stock.

The disproportionate tax burden on mutuals would have an unwarranted adverse impact on our present policyholders. One way to demonstrate this is to express the result in terms of the deductability of dividends. If our current dividend scale is maintained, we estimate that under the proposal "as is" in 1984 we could deduct only 23 percent of our dividends. We would, however, be forced to reduce our dividends by substantially over 20 percent just to pay our taxes. Such a deduction in dividends would increase the cost to policyholders of their insurance coverage. It would be an indirect tax increase for our 1.4 million policyholders.

The impact of the proposal on the level of dividend deductibility also would make it impossible for us to compete for new business. The result would be a higher-cost product for our new policyholders. This can be seen specifically in our universal life product. If we were taxed as a stock company, we would be able to credit 10½ percent interest on a universal life policy. Assuming, however, the same profit objective, if we were taxed as a mutual company, we would be able to credit only 9 percent. The cumulative effect of this 1½ percent rate differential is dramatic. An illustration prepared for a prospect age 40 would normally show values at retirement, age 65. Thus, an investment of $10,000 would accumulate to $121,000 at 10½ percent. But, at 9 percent, it would accumulate to only $86,000. The higher interest rate paid by a stock company would result in accumulation of an extra $35,000 or 40.7 percent more. That is a competitive burden which a company like Massachusetts Mutual could not endure.

The impact on our individual whole life product is equally dramatic. Individual life policies are normally compared by use of the 20-year interest-adjusted net cost. It is not necessary to go into detail here as to how this index is derived. It is sufficient if you accept that a difference in this index of 25 cents is considered competitively significant and a difference of $1.00 is competitively overwhelming. Under the proposal, the interest-adjusted cost of our individual whole life product would be $2.30 higher solely because we are taxed as a mutual company rather than as a stock. This $2.30 difference in net cost clearly leaves a wide margin for stock company profit in addition to a price differential which would drive us out of the market.

The ownership differential with its original definitions and rates also would seriously disadvantage our ability to invest in the particular types of investments that are necessary to support certain products. The fact that we and most other mutuals would always be on the minimum tax base means that we could receive no benefit from investment in tax exempts, receipt of intercorporate dividends, or realization of market discount and capital gains. Our stock competitors, however, would continue to receive these tax benefits. This would surely drive us out of certain sales and investment markets.

3. Possible alternative

A variant of the Subcommittee's proposal which would provide a tax base responsive to the economic income of each company could be created by using the Subcommittee's measurement of corporate income as a basis for partial disallowance of dividend deductibility. A law based on partial disallowance of dividends has the virtue that all items of revenue and expense except dividends are treated equally at all life insurance companies.

The problem has always been to identify the portion of dividends which should be disallowed. Arbitrary numbers are suitable only for stopgap measures. The Subcommittee's surplus earning measure provides a method by which the disallowance can be put on a sound basis. Specifically, the average equity earnings rate of stock companies could be applied to mutual company equity to determine a general mutual industry tax base. The percentage of dividends which must be disallowed on the average to produce this tax base could then be computed. This percentage dividend disallowance could then be applied to all companies. The dividend percentage would, of course, have to be recomputed periodically to ensure it is kept up to date in order to allow continued competitive equity.

4. Other

We suggest that the ownership differential should be applied to all companies, whether stock or mutual, issuing products having post-issue price adjustments. This includes universal life and indeterminate premium products issued by stock companies as well as traditional participating products issued by mutual companies. Otherwise the equity ownership of a stock company would not be recognized fully. Moreover, failure to apply the differential to all companies, both stock and mutual, would lead to competitive inequities which should not occur under a sound tax law.

B. Reserves

The proposal calls for a change in the method of calculating life insurance reserves for federal tax purposes. Under it, an insurance company could deduct increases in reserves determined by use of the acutal cash surrender value of the contract or by use of the minimum reserves required under state law.

We believe this proposal requires clarification. Specifically, clarification is required regarding its application to (1) group annuity and group life and health products; (2) individual disability and waiver of premium products; and (3) individual annuities. Moreover, application of this proposal to individual products which do not have a cash value could lead to substantial administrative problems for insurance companies and to audit problems for the government. Implementation of the new Standard Valuation Law with its dynamically changing interest rates will intensify these problems greatly.

We would suggest, as an alternative, use of CRVM reserves with valuation standards as actually reported to the states. These reserves should be subject to a cash value minimum to avoid understatement of liability.

C. Stock subsidiaries of mutual companies

Under the proposal, stock life insurance subsidiaries of mutual companies would be taxed as mutual companies if 80% or more of the stock of the subsidiary is owned by a mutual life insurance company.

This proposal seems to run counter to generally accepted principles of taxation. It is generally recognized that each corporate entity stands alone and is taxed as a separate corporation. There is no reason not to recognize this principle with respect to stock insurance subsidiaries of mutual life insurance companies. Failure to do so seems to indicate that stock companies have been given a tax advantage over mutuals and that this advantage must be denied to mutual subsidiaries in order to preserve the advantage given stock companies.

There is another reason for rejecting the proposal. The ownership differential is applied to mutual companies in order to recognize that mutual policyholders are also owners of the company. This is not true of policyholders of a stock subsidiary of a mutual life insurance company since the subsidiary is owned by the mutual company and not by the policyholders of the stock subsidiary. The theory underlying the mutual company minimum tax does not apply in a subsidiary situation.

The only rationale for this proposal is that the mutual owner of a stock subsidiary will not seek a normal profit from the operations of the subsidiary. Any company—including a stock life insurance company—can be operated at a low profit margin in order to increase market share. If fear of low profit targets justifies a minimum tax on stock subsidiaries of mutual companies, it should likewise justify a minimum tax on all stock companies.

D. Revenue topics

1. Tax revenue

The tax revenue which would be generated by this proposal has been estimated at approximately $6 billion. Since a tax of $6 billion on the life insurance industry is considered excessive, the proposal also provides that a tax adjustment will be given to each company in order to reduce the total tax revenue from the industry to approximately $4½ billion.

We believe that an industry tax burden of $4½ billion would be excessive. When stopgap legislation was enacted, it was anticipated that about $2.9 billion of tax revenue would be generated. We believe that $2.5 to $2.9 billion is a more reasonable measure of the amount of tax which should be obtained from the life insurance industry under the proposal.

It has been suggested that the result of this proposal will be that mutual companies will pay 53 percent of the total tax liability of the industry and stock companies will pay 47 percent. We understand some stock companies believe the mutual companies will pay over 60 percent of the total tax liability under the proposal and the stock companies less than 40 percent. It is not sound tax policy to attempt to achieve a preconceived distribution of the total industry tax liability between the mutual and stock segments of the industry. We urge that this be recognized in developing a permanent company tax law.

2. Taxable income adjustment

We also believe that if at all possible the permanent company federal tax law should be structured so that it will produce the tax imposed upon the insurance industry without the need for a tax adjustment. We urge that the proposal be refined to achieve this end.

3. Phase III overhang

The proposal suggests that amounts deferred in the past under Phase III of the 1959 Act should be considered in developing a permanent federal tax law. We think it appropriate that these taxable amounts be taken into account in satisfying the need for tax revenue from the life insurance industry.

III. POLICYHOLDER TAX ISSUES

A. Definition of life insurance

The proposal provides for a strict definition of life insurance using either a premiums test or a cash value test as alternatives.

We strongly endorse the strict definition set forth in the proposal. We believe it is sound tax policy to provide life insurance product tax benefits only for products which are truly life insurance and not investments disguised as insurance. Our concern is the long term protection of these benefits.

The definition developed by the Subcommittee clearly distinguishes life insurance from investment products. It will justify retention of the traditional tax benefits for life insurance since these benefits will be available only for insurance. For this reason, we urge the Subcommittee to include this definition when it reports out a bill.

B. Policy loans

The proposal provides that no tax deduction will be permitted for interest paid on life insurance policy loans in excess of $50,000 for any person. Under the proposal this restriction would apply immediately to all policies now in force but only with respect to future loans.

We have several concerns with respect to this proposal.

1. We fail to see any justification for singling out life insurance as an asset which will be limited taxwise as collateral for a loan. This is not true for other similar assets. For example the appreciated value of real estate may be borrowed without limitation. The same is true for the appreciated value of securities.

2. We believe that the $50,000 limitation on the amount which may be borrowed without loss of the deduction for the interest paid on the loan is far too restrictive. A policyholder should be permitted to borrow amounts necessary for purposes such as payment of college education expenses, medical expenses, purchase of a home, and other similar purposes. The $50,000 limitation is unduly restrictive in this regard.

3. Our greatest concern is with respect to the grandfather provision regarding the deduction of interest on policy loans. Under the proposal, the grandfather provision would be limited to loans in existence at the time the law becomes effective. We believe that the grandfather provision should include policies in existence on the effective date of the law and the new law should apply only to policies issued after the new law becomes effective. We believe this is proper because current policyholders purchased their insurance with the understanding that interest on loans on the policies would be deductible. Thus, the new law should apply only to policies issued after the law becomes effective.

C. Basis adjustment

Under the proposal the aggregate premium paid for the contract would be reduced by the cost of the insurance provided in determining the policyholder's basis in the contract upon surrender of the contract or cash withdrawal from it.

We oppose this proposal for a number of reasons. First, it would be a form of indirect tax increase on individual policyholders accomplished thru a technicality in the tax law. Second, basis for other assets is not adjusted by the benefit derived from the use of the asset. For example, a homeowner's basis is not adjusted by the value of the use made of the house by its owner. Finally, with a tough definition of life insurance there should be no reason to curtail the tax benefits traditionally accorded owners of life insurance contracts. The proposed change in basis would do just that and is unwarranted.

APPENDIX

Chart I.—Stark/Moore Proposal, Estimated 1981 Impact.

Chart II.—Stark/Moore Proposal, Estimated 1982 Impact.

Chart III.—Stark/Moore Proposal, Estimated 1983 Impact.

Chart IV.—Stark/Moore Proposal, Estimated 1984 Impact.

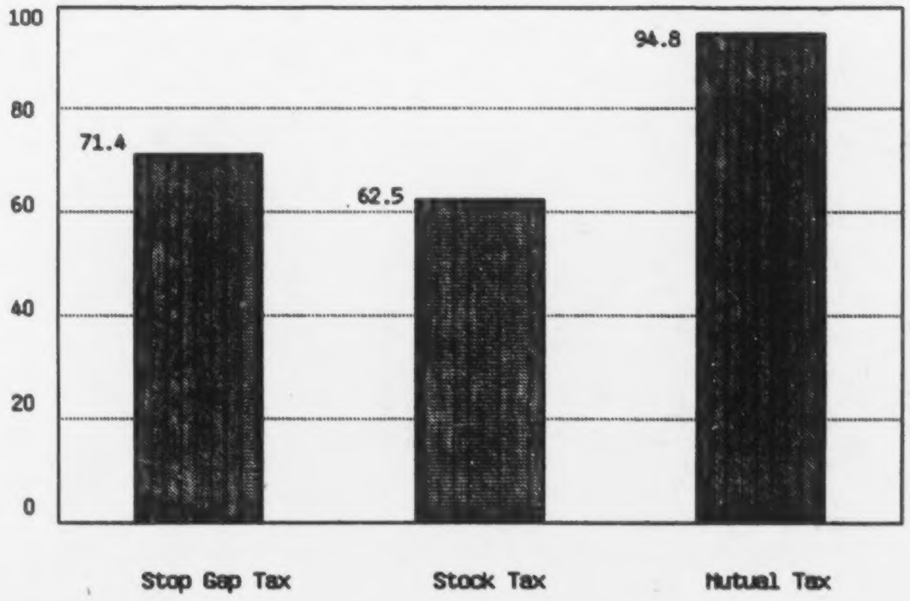
Chart V.—Stark/Moore Proposal, Dividend Deductibility Limitation, Dividend Maintained.

Chart VI.—Stark/Moore Proposal, Dividend Deductibility Limitation, Profit Maintained.

CHART I

Stark/Moore Tax Proposal

Massachusetts Mutual Estimated 1981 Tax Impact

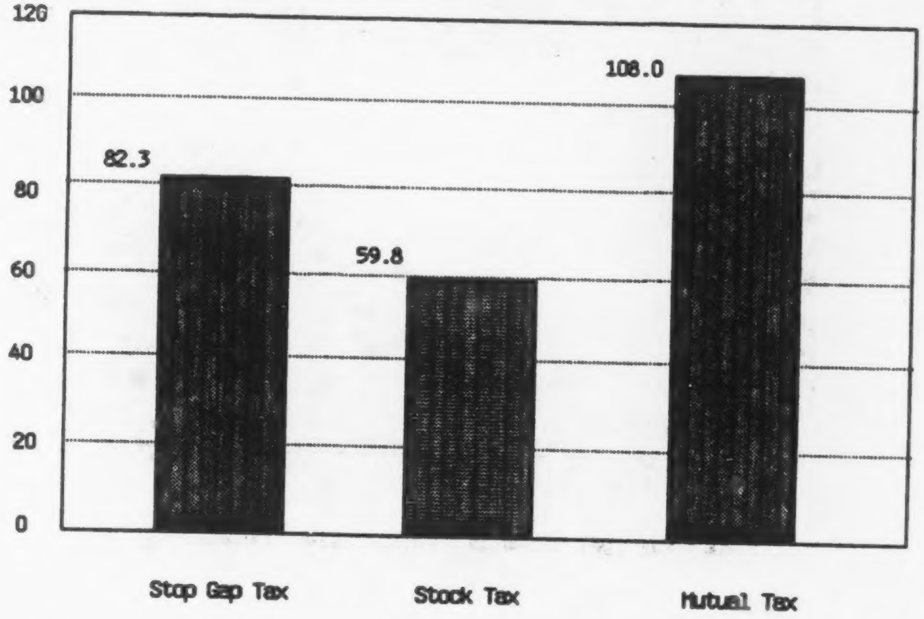


Figures In Millions of Dollars

CHART II

Stark/Moore Tax Proposal

Massachusetts Mutual Estimated 1982 Tax Impact

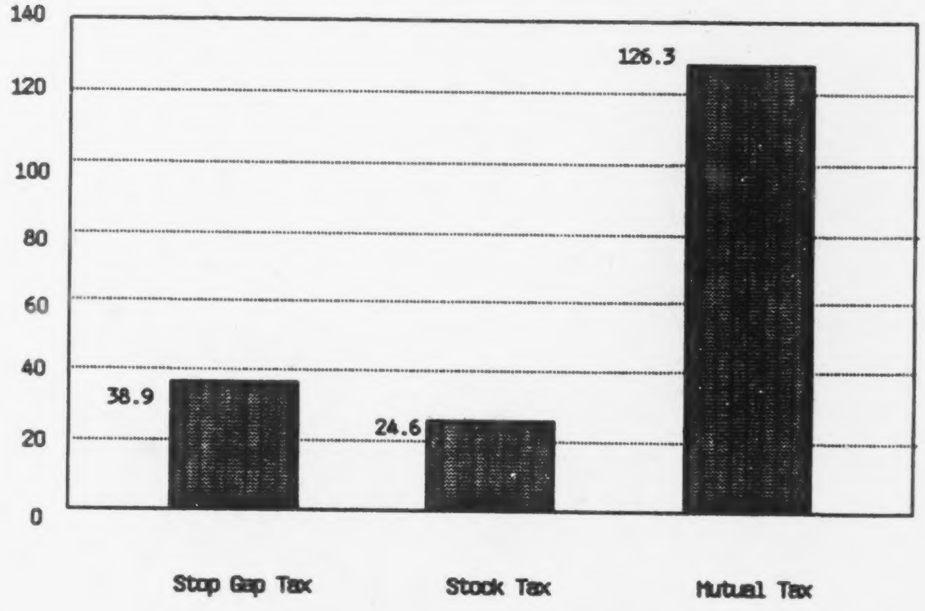


Figures in Millions of Dollars

CHART III

Stark/Moore Tax Proposal

Massachusetts Mutual Estimated 1983 Tax Impact

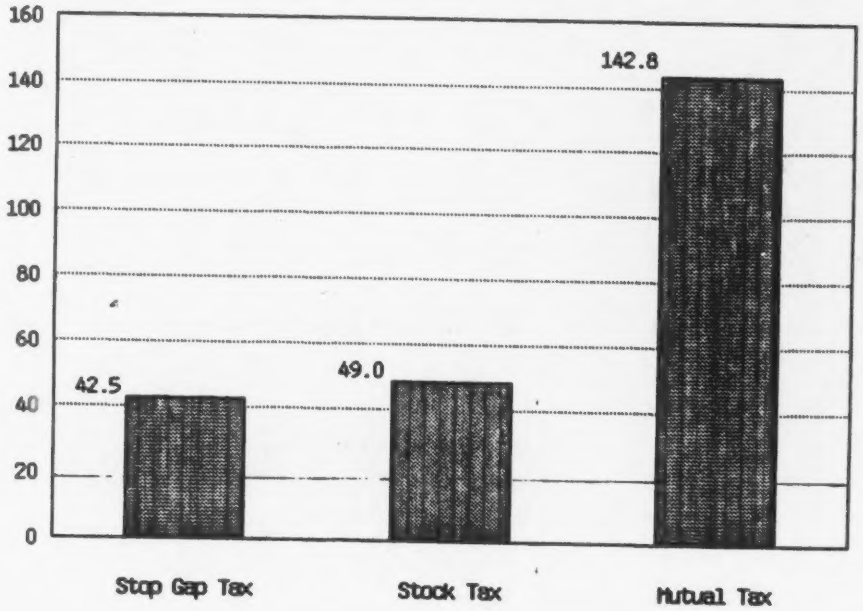


Figures in Millions of Dollars

CHART IV

Stark/Moore Tax Proposal

Massachusetts Mutual Estimated 1984 Tax Impact



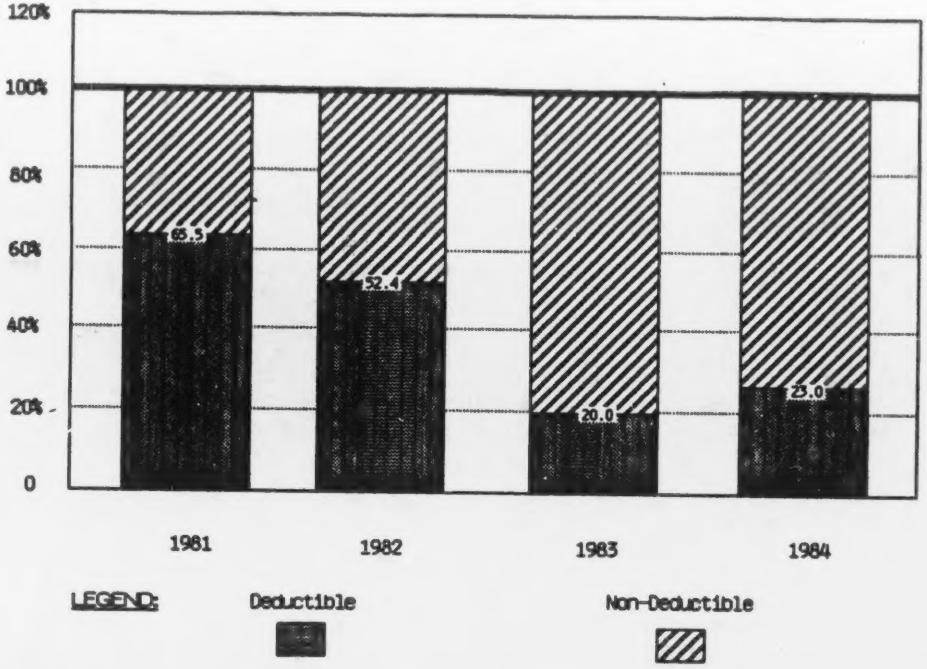
Figures in Millions of Dollars

CHART V

Stark/Moore Tax Proposal

Massachusetts Mutual Dividend Deductibility Limitation

Dividend Scale Maintained - Profit Cut



GLASTONBURY, CONN., *May 5, 1983.*

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: Although I have been retired as an actuary for several years, I have become aware through the press and conversations with former colleagues of the violent pulling and hauling that has been taking place recently with respect to the manner of taxation of life insurance companies.

My actuarial work included time with a state insurance department and, as an officer of a life insurance company, acquaintance with the 1959 Act from its beginnings. Its many complexities are known to but few within the acturial profession and are of course totally incomprehensible to those outside it. Thousands of man-hours and million of dollars have been and are being spent by the industry in dreaming up new devices for minimizing tax, and by the IRS with limited manpower, in attempting to scrutinize these schemes and maximize revenue.

It seems to me that it is time to cut the Gordian knot and go to a federal premium tax. Its revenue potential could be easily estimated, a great advantage to both industry and the Treasury. It has, of course, been used by the States for many years without serious adverse impact. Administration by the IRS would be simplicity itself.

The principles of such a measure should follow state premium tax laws, except that premiums on qualified pension plans should be excluded, in line with federal tax policy favoring such plans.

The tax should apply to direct premiums, less dividends, on life, health and property/casualty business. The same rate of tax should apply to benefits paid under self-insured plans, with the same exclusions of qualified pension plans.

Obviously, the rate at which the tax should be imposed is a matter for negotiation. A range of 1½ percent to 2½ percent would appear to meet Treasury revenue objectives and at the same time be commensurate with current levels of state premium tax.

Sincerely,

ROBERT MERRITT.

MINNESOTA MUTUAL LIFE,
St. Paul, Minn., July 28, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means.

DEAR MR. STARK: We want to thank you and the other Members of the Subcommittee for their vigorous efforts to develop new tax legislation for life insurance companies to be effective in 1984, and for the opportunity to react to the Stark/Moore proposal.

We endorse many of the basic concepts in the proposal but believe that some changes should be made. Without significant fine tuning, the proposal would levy enormous taxes on our Company which in turn would be passed on to our policyholders. They in turn would find our life insurance product to be less attractive. Many would surely consider finding some alternative to continuing their insurance, given the higher prices generated through higher, possibly confiscatory new taxes.

Our 1984 estimated taxes under the Stark/Moore proposal, the 1959 Act and Stopgap are as follows:

	Million
Stark/Moore proposal, tax on economic income (with full deduction of dividends)	$7.8
Stark/Moore proposal, tax on minimum equity return base	24.6
1959 act	22.0
Stopgap	2.0

Under the Stark/Moore proposal, our Company would only be allowed a deduction of 35 percent of policyholder dividends in 1984. The 1959 Act would allow a deduction of zero percent! I would underscore the significance of this by noting that these figures relate to all dividends to policyholders, including ordinary, group and pension policies.

Taxes of the magnitude of $22.0 million or $24.6 million would produce results which would be very offensive to our policyholders, as the increased taxes would be reflected in increased premiums or decreased dividends. They would cause a devastating increase in prices to our customers.

The purpose of the remainder of this letter is to comment briefly on several specific points of your proposal.

1. Single Phase Tax Structure.—We support a single phase tax structure based on economic income, applicable to both stock and mutual companies. However, the current proposal does not produce this result. Under the current proposal, our Company is taxed on the minimum equity return tax base which is well in excess of our economic income. We expect this would be true in the foreseeable future.

2. Definition of Life Insurance.—We endorse the concept of a definition more stringent than that provided in TEFRA.

3. Ownership Differential and Minimum Tax.—(a) We believe that any tax on imputed income, the "minimum tax," should logically and equitably apply uniformly to stocks and mutuals. (b) The suggested tax on imputed income set forth in the Stark/Moore proposal is too onerous. It overstates imputed equity. It overstates imputed earnings on equity. Any imputed earnings should relate uniquely to each company. While it is difficult to accurately estimate, we believe that a rate of return equal to a company's overall net investment income rate will generate the best estimate of earnings.

4. Taxable Income Adjustment.—We believe that the use of an arbitrary 25 percent reduction is a reflection of the fact that the basic calculation produces taxable income which is too high. It is more desirable to reduce the basic tax than use an arbitrary reduction factor.

5. Stock Subsidiaries of Mutuals.—The taxation of a company should be independent of its ownership.

6. Spreading Reserve Adjustments Over a Ten Year Period.—These amounts should not be taken into future income. The proposal mandates important reserve reductions. Our company experienced only a limited tax benefit in prior years from currently held reserves. A release of those reserves or any part thereof does not generate any real income; and, certainly should not generate any taxable income beyond the level of tax benefit previously enjoyed by each company from the reserve deduction.

7. Premiums Adjustments.—The Stark-Moore proposal indicates that premium adjustments are to be treated as policyholder dividends. At this state of development, the concept of "premium adjustments" is not defined. The ultimate definition may be critical to our Company. We issue a term policy that is designed to cover the unpaid indebtedness under mortgages. Premiums on this policy generally are not guaranteed. This particular coverage is written extensively by our Company and comprises approximately 50 percent our our life insurance in force.

It is a unique product in some respects. While it can be written either as group policies or individual policies (½ of in force and ¼ of new issues are on an individual basis), the premiums, marketing and administration are essentially identical. The differences between the coverage written on the individual policy form and the group form are only technical in nature.

When the law and regulations are ultimately written it is apparent to us that, with respect to group term life insurance, it will be made clear that there will be neither inputed dividends nor imputed premiums at a level above the rates actually remitted by the policyholders. Nevertheless, it is conceivable to us that such a clarification may not be specifically set forth for individual term life policies unless special attention is drawn to this matter. We believe that both group and individual term life policies should not be treated as providing for imputed dividends. In all events, individual term policies substantially similar to group policies, such as our policies, should not be so treated.

Despite the major impact which this item may have on our Company and on our clients, we are treating it herein in what is essentially a "notice" form. We would appreciate the opportunity to discuss our concern in greater detail with you or your staff during the drafting process.

Thank you again for the opportunity to comment on the Stark-Moore proposal. If we may answer any questions concerning any of these isues, please call me or Dale Kain of our office.

Very truly yours,

COLEMAN BLOOMFIELD,
Chairman of the Board and President.

THE MUTUAL LIFE INSURANCE CO. OF NEW YORK,
New York, N.Y., July 28, 1983.

Re tax treatment of life insurance companies and their products.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: In accordance with the invitation contained in the July 14 Press Release of the Subcommittee on Select Revenue Measures, 25 copies of this statement are hereby submitted on behalf of The Mutual Life Insurance Company of New York ("MONY"), for incorporation in the printed record of the hearing scheduled for July 28, 1983.

MONY is one of the oldest and largest life insurance companies in the United States. Presently it ranks thirteenth in size among all life insurance companies and ninth among mutuals.

We strongly oppose the concept of a minimum tax on imputed income from surplus. We oppose also the use of such a concept for calculating an ownership differential, limiting the deductibility of policyholder dividends. The concept is unsound in principle, for reasons expressed in a separate statement submitted for the record by a group of several mutual companies, including MONY.

Under MONY's particular circumstances, based upon 1982 financial data, our estimates show that the amount of the deductible premium rebate, after calculation of the proposed ownership differential, would be less than 12 percent of the dividends paid to our policyholders. This falls far short of any estimates we have seen for the rebate element in policyholder dividends. Even the 60 percent allowance suggested by representatives of the Stock Information Group at the Subcommittee's May, 1983 hearings is five times the allowance under the current proposal, and TEFRA allows 77.5 percent.

In 1982, MONY's Annual Statement gain from operations before policyholder dividends and Federal income tax was approximately $285 million. Under our best estimate of tax adjustments required under the proposal, the tax base is $231 million. Our total policyholder dividends for that year were $263 million and our surplus base is estimated at $875 million. Under the 23 percent Subcommittee proposal, this results in an arbitrary assignment of earnings to surplus of approximately $200 million. On the basis of these figures, it is estimated that only about $31 million of dividends to policyholders would be deductible.

There are several reasons for the peculiar distortion in the case of MONY:

First, our Company maintains a relatively high statutory surplus. Over the years, MONY has attempted to build its surplus to offset the hazards of a rapidly changing economic and business environment. We have little recourse to other means for raising capital to support the growth of our business and for possible diversification, other than to gradually increase the level of surplus out of already taxed gains from operations.

Second, MONY's dividend reserve is high in light of our history of offsetting high premiums with comparably high rebates in the form of dividends to our policyholders. If MONY continues this practice, it is clear that it would be penalized when compared with companies which provide insurance at the same net cost but accomplish this by charging lower premiums and paying lower dividends.

Third, under the proposal, the Mandatory Securities Valuation reserve is treated as part of surplus, but no offsetting factor recognizes that many of our older investments carry relatively low interest rates and consequently have a market value substantially below statement value.

Fourth, our MSVR tends to be high because of the nature of our assets: we believe that common stocks are desirable investments which ultimately will accure to the benefit of our policyholders, and it is our policy to aggressively lend to sound but lesser known companies which do not have ready access to the public capital markets. National Association of Insurance Commissioners rules require substantial MSVR balances for both types of investments.

Lastly, the 23 percent earnings rate, while it would be applied to all mutual companies, would have a disproportionate impact on MONY because of its high surplus base under the proposal.

Our policy of maintaining a strong surplus is a prudent step toward protecting our soundness as a financial company with strong fiduciary responsibilites. We have no ultimate recourse to a Federal "lender of last resort." Nor do the great majority of our policyholders have any recourse to a Federal guaranty corporation. Artificial and excessive imputation of tax to this surplus, levied quite apart from the investment, expense and mortality experience of the Company as a whole, attaches a heavy cost to this exercise of business judgment, and will inevitably tend to restrict sound financial planning.

If it is deemed necessary to tax an ownership element in the mutuals, we strongly recommend that the equitable and tax neutral way to do so is to provide differing percentage deductions for dividends paid. This forthright recognition of the difference in ownership avoids building into the Internal Revenue Code a tax deterrent to sound financial operation. Additionally, we believe that any differential granted to stock companies should be predicated on their actual distribution of dividends to stockholders as illustrated in the enclosed exhibit.

We recommend also that if it is deemed necessary to have a minimum tax, that it not be in the form of an imputed tax on surplus but based on economic income, that is, on gain from operations before individual life and nonqualified annuity dividends.

Very truly yours,

HENRY S. ROMAINE, *President.*

EXHIBIT A

The following assumes that the Congress recommends a formula providing for a substantial dividend deduction, and for stock companies to receive a larger deductions than mutual companies.[1]

The dividend deduction differential should not be based on the assumption that every stock company pays substantial dividends to shareholders. On the contrary, the availability of an increased deduction for stock companies should depend in part upon whether the stock companies do actually pay shareholder dividends.

Following this thought, the dividend deduction would be fixed at "X" per cent for both stocks and mutuals, but stocks could include in the base against which the percentage is applied their dividends paid in cash to shareholders as well as dividends paid to policyholders. In no event could the deduction exceed "X" plus "Y" per cent of dividends to policyholders, with "Y" representing the agreed upon spread.

The virtue of this formula is that it does not grant the full spread unless stockholder dividends paid by the stock company equal or exceed the differential. A stock company which is heavily into Universal Life and has stockholder dividends of nominal amounts would not receive the full differential.

As always, there are technical points to be worked out. For instance, we recommend some mechanism to avoid sham dividends to a parent which are promptly reinvested in the stock subsidiary.[2]

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
May 9, 1983.

Re proposals for tax treatment of life insurers.

Hon. FORTNEY H. STARK,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE STARK: We appreciate your letter of April ;5, 1983 requesting our comments concerning the hearings to be held on May 10 and 11 by your Subcommittee, the Select Revenue Measures Subcommittee of the House Ways and Means Committee, which will consider tax legislation affecting the insurance industry. If appropriate, please include these coments on the hearing record.

The National Association of Insurance Commissioners (NAIC) is comprised of the chief insurance regulatory officials of the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Samoa, who are responsible for maintaining the financial health and solvency of the insurance industry and its responsiveness to the insuring public. As such, we are particularly interested in the effect of federal taxation on that insurance industry.

In his remarks on March 11, 1983, Assistant Treasury Secretary for Tax Policy, John E. Chapoton, stated that the Treasury Department is interested in reviewing the laws regarding the maintenance of reserves by insurers. We would urge caution if this review is conducted because of the essential relationship between insurer solvency and reserving practices. It is because of this relationship that insurers reserving practices are, in large part, governed by state law and are so closely scrutinized by state insurance regulators. Specifically, the reserves required by statutory accounting principles are designed to assure the financial solvency of the industry. IRS acceptance of these principles has been a major prerequisite to effective compliance. Thus, any changes in the tax laws which should have the effect of diminishing the ability of insurers to maintain adequate reserves would threaten the health of the insurance industry and would be detrimental to the insuring public.

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[1] Presumably, the differential would be in lieu of any other advantage granted to stocks, e.g., the 50 per cent deferral of underwriting income, the nonpar deduction, etc.

[2] This might be accomplished by recognition of the nontaxability of stock company paid-in capital and reducing stockholder dividends by such amount.

The NAIC is anxious to assist your Subcommittee in the development of legislation which will not only create fair and equitable tax legislation, but will protect the financial health of that industry for the benefit of the insuring public. We look forward to providing any further comments and information which you may consider to be helpful. We do wish to remain closely involved with this process due to its importance to the consumers whom we serve.

Sincerely,

ROGER C. DAY, *President.*

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
July 27, 1983.

Re life insurance income tax proposal advanced by Chairman Stark and Representative Moore of the Select Revenue Measures Subcommittee.

Hon. FORTNEY H. STARK,
Chairman, Select Revenue Measures Subcommittee, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE STARK: The National Association of Insurance Commissioners (NAIC) has previously corresponded with your committee expressing our concern and interest in the proposed changes to the tax treatment of life insurance products and companies. A copy of our letter of May 9, 1983, is enclosed.

As we expressed in our previous letter, the NAIC is very interested in any legislation that would have an impact upon the financial health and solvency of the insurance industry. We note with particular interest that your proposal addreses the treatment of reserves. The reserves required by statutory accounting principles are essential to maintain insurer solvency.

The NAIC is looking forward to working with the subcommittee in the development of this legislation. we will be conveying to the subcommittee more comprehensive comments when your proposal is drafter in legislative form.

Sincerely yours,

ROGER C. DAY, *President.*

NEW YORK LIFE INSURANCE CO.,
New York, N.Y., May 9, 1983.

Re hearing of May 10 and 11, 1983, taxation of life insurance.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: This letter is being sent to you in connection with the Hearing described above in accordance with Press Release No. 3 by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means.

We have reviewed the Mutual Company Statement on Life Insurance Company Tax Legislation For The Subcommittee on Select Revenue Measures dated May 10, 1983.

This is to advise you that New York Life Insurance Company supports fully that Statement as a proper approach to adopt for the taxation of life insurance companies. However, we suggest that the definition of life insurance, referred to on page 25 of that Statement, is too restrictive. Any definition of life insurance for purposes of § 101 of the Internal Revenue Code should build on the definition that is now in the Code, with possible modification to prevent any possible abuse in the future.

We appreciate the opportunity to submit this statement as a part of the record for the Hearing described above.

Yours truly,

HARRY G. HOHN,
Executive Vice President and General Counsel.

○

STATEMENT OF DONALD K. ROSS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, NEW YORK LIFE INSURANCE CO.

New York Life Insurance Company is the fourth largest mutual life insurer in the United States, with assets in excess of $23 billion. It has been selling participating life insurance since 1845, and more recently has also sold nonparticipating insurance and annuities through a stock life insurance company subsidiary.

At the outset, New York Life would like to express its support for the elimination of the present three-phase pattern of taxation applied to life insurance companies. We applaud the objective of a single-phase tax structure. Nevertheless, we express strong opposition to the proposal contained in the Committee Print of July 14, 1983 because it would not only fail to provide a single-phase tax structure for mutual life insurance companies, but would also create a new three-phase pattern (illustrated on the attached chart) that would produce results as arbitrary and unfair as the current three-phase system.

OWNERSHIP DIFFERENTIAL

We believe the case for an "ownership differential" that taxes mutual companies more heavily than stock companies has been based entirely on theoretical analyses that do not take into account the realities of the marketplace. A purchaser of life insurance seeks simply to acquire adequate protection at the lowest net cost. The need for life insurance and the desire to minimize costs guides his choice when purchasing coverage. The purchaser of a policy, whether from a mutual company or from a stock company, does not view that purchase as one of an ownership interest in the company. While there may be a legal distinction between the position of a mutual company policyholder and that of a policyholder in a stock company, this difference is not relevant in the selection of a policy and becomes financially significant only in the unlikely event of the liquidation of the company.

Policyholder dividends and other price adjustments are illustrated and paid by both mutual and stock life insurance companies. A "differential" theory that treats some part of a price adjustment for a mutual policyholder as a return on equity ignores reality. Further, an excessive differential that would enable stock companies to quote to prospective policyholders a lower net cost for individual life insurance than mutual companies would make mutual companies noncompetitive.

We submit that there should be no differential for individual or group policies that are used to fund qualified retirement plans. This is because any differential would make mutual companies noncompetitive with uninsured trusteed plans which are tax exempt and which have proliferated largely because of this tax imbalance. Similar competitive considerations would rule out a differential for products providing accident and health insurance as well as group life insurance coverages.

If Congress is convinced that some differential for individual life insurance is justified, then any such differential should be reflected only in the deduction allowed for dividends credited to individual life insurance policies. In our view, the dividend deduction for mutual companies should be at least 95 percent, so that if stock companies are allowed to deduct 100 percent of the amounts they credit to individual policies, the differential would be small enough to preclude a severe competitive disadvantage for mutual companies.

STOCK SUBSIDIARIES

As deregulation by Congress of the banking and financial services industry moves ahead, mutual insurance companies will be faced with new kinds of competition. In order to respond to both present and future competitive pressures, mutual companies must be free to issue nonparticipating products through their stock life insurance subsidiaries without any competitive disadvantage that is imposed by the tax laws. The Subcommittee's proposal, however, would create a new competitive disadvantage at just the time that Congress is unleashing new competitive forces in the marketplace.

Even today, virtually all stock life insurance companies are owned by other corporations. Some are owned by holding companies, which themselves are often owned by manufacturing corporations or are part of financial services conglomerates. Other stock life insurance companies are owned by mutual property/casualty insurance companies. In each of these cases, dividends from a stock life insurance company are not taxable to its corporate stockholder, and tax is not levied or proposed on the surplus of the insurer or its parent corporation. Indeed, the conglomerates that today dominate the stock life insurance industry are far more interested in the stock company's contribution to the conglomerate's consolidated earnings per share on a GAAP accounting basis than in its cash dividends.

We submit that in order to remain competitive with other financial service organizations, mutual life insurance companies must be free to sell their products on the same terms as stock life insurance companies which sell non-participating products. If mutual life insurance companies cannot sell certain products directly, they must be allowed to sell those products through stock subsidiaries in order to remain competitive. Further, it should be noted that if the tax laws prevent stock subsidiaries of mutual life insurance companies from selling certain products, the mutual companies would simply cease to engage in that segment of business and stock subsidiaries of other organizations would make those sales. It is our belief that preventing mutual companies from competing through stock subsidiaries would not help the tax revenues but would simply reduce healthy competition within the industry.

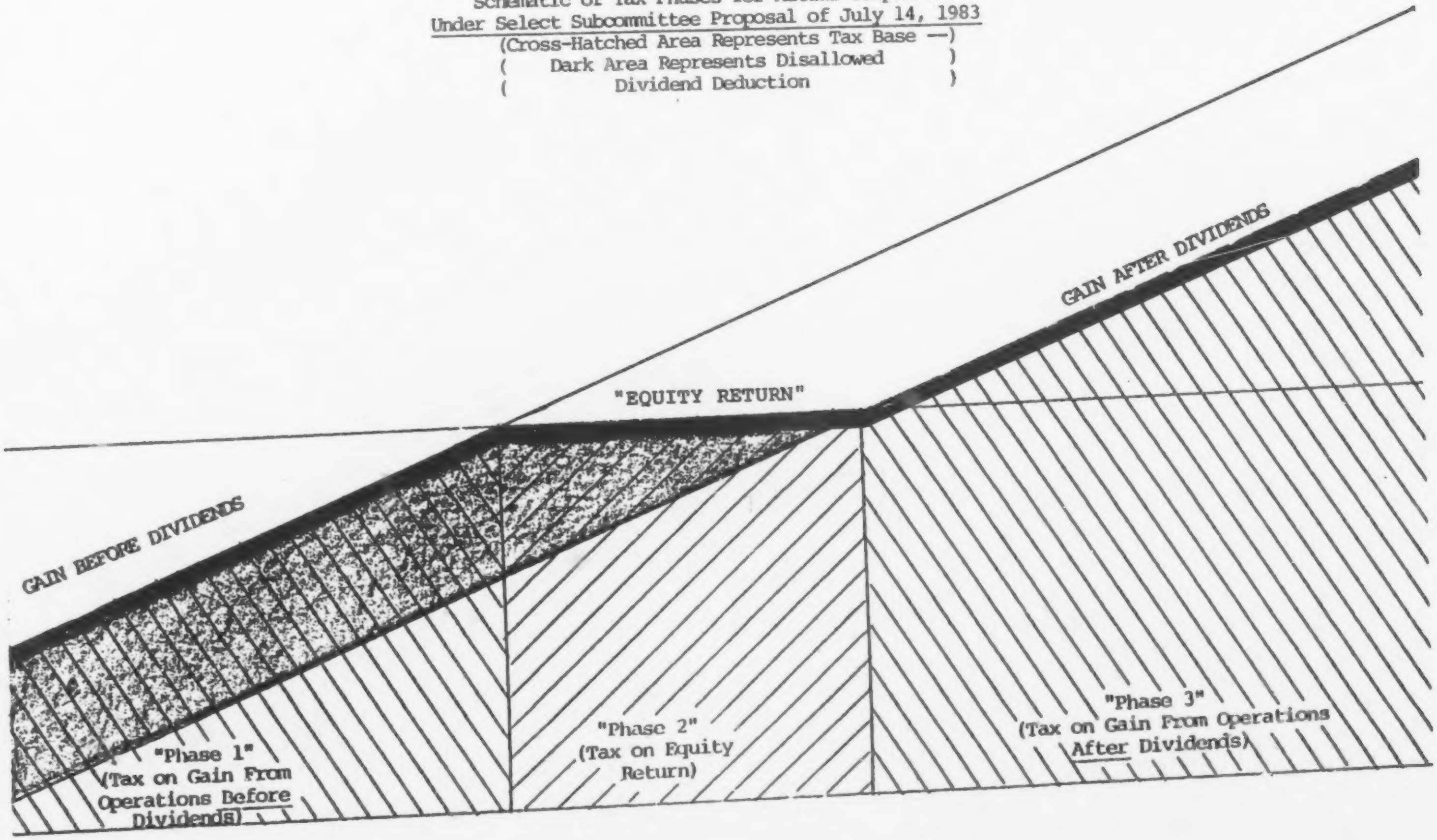
CONCLUSION

We urge the Subcommittee to be cognizant of the rapid pace of change in the financial services marketplace. Mutual companies cannot compete if they are saddled with federal income tax costs that prevent them from offering insurance at competitive prices. Moreover, the relevant competitive arena contains both stock life insurance companies and other types of financial institutions competing for the same dollar.

New York Life has served the American public for nearly 140 years. If its products are to be rendered noncompetitive through taxation, it will no longer be able to serve the American consumer and American industry which have looked to it for insurance coverage and long-term financing from the beginning of the industrialization of the United States.

Attachment.

Schematic of Tax Phases for Mutual Companies
Under Select Subcommittee Proposal of July 14, 1983
(Cross-Hatched Area Represents Tax Base —)
(Dark Area Represents Disallowed)
(Dividend Deduction)


GAIN BEFORE DIVIDENDS
"EQUITY RETURN"
GAIN AFTER DIVIDENDS
"Phase 1" (Tax on Gain From Operations Before Dividends)
"Phase 2" (Tax on Equity Return)
"Phase 3" (Tax on Gain From Operations After Dividends)

STATEMENT OF THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.

MAY 25, 1983.

This statement will be divided into several sections. The first three brief sections will comment on the Northwestern Mutual Life Insurance Company and what it stands for, express support for the mutual company positions as stated at the hearings on May 10 and 11, and comment (generally supportive) on the Treasury Department statement made by Assistant Secretary Chapoton.

The next portion will explore certain aspects of the so called Ownership Differential that have not been adequately addressed in our opinion. This portion will include comments on certain related issues; namely, the nature of policyowner dividends and the concept of a minimum tax. The final portion will be a brief summary.

THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.

The Northwestern Mutual Life Insurance Company has been in business 126 years and its assets of $13 billion rank it 9th among all U.S. life companies, and 59th among all U.S. business enterprises.

Northwestern Mutual writes only individual life insurance, annuity and disability insurance policies. As its name implies, it has no stockholders and sells only participating insurance. It is known throughout the industry for its quality operation and ability to provide low cost insurance to its policyowners.

Our watchword has always been to treat all policyowners fairly. With the advent of high inflation and high interest rates in recent years, we have offered several Update programs to improve benefits and values for our policyowners, new and old.

SUPPORT MUTUAL COMPANY STATEMENTS

We believe that the positions expressed in the mutual company statement are consistent with sound tax policies, are an appropriate foundation for the development of a permanent tax law for the life insurance industry, will develop revenues consistent with the real economic income of life insurance companies, and will assess that revenue fairly among the various taxpayers in the industry.

TREASURY DEPARTMENT STATEMENT

While we have not yet had the opportunity to study the statement presented by Mr. Chapoton in great detail, we believe that there is a rather high order of consistency between the concepts expressed in the Treasury Department statement and our own understandings.

We are in agreement with the general thrust of Mr. Chapoton's remarks regarding reserve revaluation, gain deferral and the special deductions. We are concerned about some of the implications of his comments regarding the equity ownership of a mutual company, the nature of policyowner dividends and the competitive relationship between stocks and mutuals. As stated in the first paragraph a major portion of this statement will explore these and related matters.

With regard to the tax treatment of policyowners, we believe that a carefully drawn, more comprehensive definition of life insurance is the most effective way to address this area. Such a definition would make it unnecessary to develop any major revisions in the present rules regarding surrenders, withdrawals and policy loans, with respect to products properly treated as life insurance.

OWNERSHIP DIFFERENTIAL

A great deal of effort has been expended in discussing the fact that the corporate structure of a mutual life insurance company is different in some respects from the corporate structure of a stock life insurance company. We must confess that in our opinion some of those efforts have included some embarassingly wild flights of fancy as to how large a tax differential should be to reflect the purported ownership differential. In fact, we reject this recently developed suggestion that a mutual company policyowner has an economic interest in the firm separate and distinct from his interest as a customer. We emphatically endorse the position expressed on a number of occasions by mutual companies that there is no sound tax policy, actuarial or legal principle that justifies the reflection of any ownership differential in taxation. Nevertheless, while we reject the ownership differential concept, we do not shrink from examining it.

Most of this section will be devoted to an analysis of some of the fallacies in specific methodologies that have been and are being suggested for quantifying a tax differential. Assuming that it might be necessary to reflect a differential in the tax laws for political or competitive reasons, we offer some suggestions about the kind of methodology that can produce a more realistic quantification of a tax differential.

Ownership difference methods currently suggested

The common flaw that runs through all the methodologies is that they are somehow based on the financial results of stock life companies. This should give one pause. What sound tax theory is it that says that the profitability of one group of taxpayers should be a key determinant of the taxation of a different and unrelated group of taxpayers? We suggest that this new tax theory deserves very careful sorting before it is adopted. If one accepts this new theory for the moment, then a secondary flaw runs through virtually all of the methodologies, it being they are based on some form of aggregate comparisons of the financial results of mutual companies and stock companies for recent years. Many products issued by stocks and mutuals currently are quite comparable—group annuities, group insurance in general, and some individual health policies are examples. The risk of adverse changes in experience factors is predominantly borne by the policyowners in these lines. Thus the pricing and risk characteristics are similar whether issued by a stock or mutual company. The major individual life insurance permanent product issued over the past several decades has been significantly different between the two kinds of companies. The mutual companies have almost without exception issued participating permanent life insurance policies. On the other hand, most stock companies have issued exclusively or predominantly nonparticipating individual policies.

The pricing and risk characteristics of these two products are significantly different. While both provide a fully appropriate mechanism for the pooling of individual risks, they differ markedly in how they handle long-term changes in the underlying experience factors.

Nonparticipating life insurance guarantees all benefits and the gross premium for the life of the contract. Thus, nearly all of the risk of adverse changes in underlying experience factors are borne by the company, and its shareholders. On the other hand, the very essence of participating life insurance is that the body of policyowners shares completely in the changes in experience of the underlying factors. While, as stated before, both kinds of products fully reflect the individual risk-sharing, the risks of overall changes in interest rate levels and mortality levels are borne exclusively by the shareholders under nonparticipating insurance, whereas those risks are borne by the body of policyowners under participating insurance.

Because stockholders bear nearly all of the risk, profit margins are typically larger in nonparticipating insurance than in participating. More important, over the past 30 years, with continually increasing interest rates and improving mortality, the profits on blocks of nonparticipating insurance have been very large indeed. (This experience of several decades certainly raises a question of the need for any special tax treatment for traditional fully guaranteed non-participating policies.)

The point of all this however, is to observe that virtually all of the methodologies suggested by those who argue for a substantial differential have ignored this fundamental difference in inherent profit levels. The methodologies have attempted to impute to the mutuals the unusually high level of profits currently being enjoyed by the stock companies on their blocks of nonparticipating insurance. Thus, they compare apples with oranges. The next several sections will develop an analytical basis for evaluating the differential issue with the removal of incorrect comparisons.

Equity distributions to policyowners, (or can they have their cake and eat it too?)

Significant insight can be gained by an examination of published financial statement data as to whether or not Mutuals distribute a portion of return on equity as a part of policyowner dividends. In 1979, gain from operations after policyowner dividends (before taxes) for mutual company members of the American Council of Life Insurance was 29.77 percent of book value (capital, surplus, etc.). The corresponding ratio (before taxes and shareholder dividends) for the stock company members of the American Council of Life Insurance was 24.65 percent. A potential obvious question arises from these ratios. How can it be alleged that Mutual's distribute a part of the return on equity when the portion retained is larger than the Stocks' return on equity before dividends to shareholders? A dollar of earnings can either be retained or paid out, it cannot be both retained and paid out.

Then it might be alleged that Mutuals have relatively less net worth because a part of it is actually held by the policyowner. That is absurd on its face, because the policyowner's relationship with his company are contained entirely within the four corners of his insurance policy and it contains no provisions related to economic ownership. The truth is that net worth will vary widely as a percent of assets among insurance companies, both stock and mutual. This variation reflects many things, but a very important factor is the risk related to the products issued. For a long time, the individual products issued by the stocks (non-participating) have been felt to have a larger risk component than the products issued by mutuals (participating). In many instances, this perception of greater risk may lead to greater capitalization of a stock company, or may be reflected in the retention of earnings attributable to high profit nonparticipating business as previously noted.

More detailed supplementary comments on equity distributions and the nature of dividends to policyowners are attached. It includes a discussion of the testimony of the witnesses on May 10 and 11 and asserts that their testimony is consistent with the proposition that if a mutual retains all of its "equity earnings" rather than distributing them, it is in the same tax position as a stock. Thus there is no "tax advantage".

SURPLUS BELONGS TO THE POLICYOWNERS IN A MUTUAL (AS CUSTOMERS, NOT AS EQUITY OWNERS)

A number of experiences from the past bear directly on the allegation that the net worth of a Mutual belongs to the policyowners in an equity sense.

These few examples below indicate that the idea that the net worth of a Mutual represents the policyowners' equity interest as owners is in opposition to established law and practice in life insurance history.

During the late 19th and early 20th century essentially the same from of participating insurance was offered by both stock and mutual life insurance companies. Abuses in that particular product form led to the famous Armstrong investigation of the life insurance business by the New York State Insurance Department late in the first decade of this century.

In much oversimplified summary, the investigation's two key concerns were the inability of the mutual policyowner to control the management of his company and the conflict of interest inherent between the policyowner and the shareholder in a stock company issuing participating insurance. Legislation establishing more effective procedures for corporate governance of mutual life insurers from the policyowners' point of view was enacted. Legislation to provide the policyowner with some say in the management of a stock company issuing participating insurance was defeated. It is, nevertheless, a fact that a number of stock companies, including the three largest companies (still the three largest), were mutualized. The mutualizations converted about 60 percent of the then stock segment of the business. It is also true that as time went on, specific limits on the profits that might be allocated to the stockholders out of the earnings on participating insurance were developed. More on this a little later.

Case law has generally held that the surplus of a stock company issuing participating insurance belongs to the policyowners, except for the specifically defined equity of the shareholders.

The largest stock life insurance company (the Aetna) has issued a modest amount of participating life insurance throughout nearly all of its history. By company charter provision, no profits from that participating business may inure to the shareholders. That charter provision was revised to provide that a limited amount (10%) of the earnings on participating policies issued after January 1, 1968 might be allocated to the shareholders.

Comparisons based on similar products

As noted earlier, a regulatory limit applies to gains on participating insurance issued by stock companies. Typically that limit provides that not more than 10% of the gain from operations before dividends may redound to the benefit of stockholders. This limit or some variation of it is actually imposed by only a relatively few states. However, because those few states are very prominent, the limit actually applies to the vast bulk of participating insurance issued by stock companies. If one takes that limit into account and examines two otherwise similar companies, one mutual and the other stock, some rough ideas of what the alleged tax disadvantage might look like emerge.

An ownership differential, if there is such a thing, should not be based on a specific product. In spite of that fact, much of the discussion and the provisions of TEFRA have largely focused on individual participating life insurance. Because of that background, consideration of an ownerhip differential in the frame of reference of a similar participating product issued by both kinds of companies may be instructive even though an ownership differential based on a specific product would be fundamentally inappropriate.

Two major new forms of life insurance products have been introduced widely in very recent years. Universal Life has largely been described as an "unbundled" whole life insurance policy under which interest and mortality charges may be determined annually, or even more frequently. Indeterminate premium whole life insurance has been derived from old-fashioned nonparticipating whole life insurance, but it is fundamentally different from it. The company issuing such a contract will identify an actual level of premium to be paid that is significantly lower than the guaranteed maximum premium in the contract. The company expects to change the premium actually being charged to reflect changes in future experience factors, as they become evident.

Without going into any details of product design it is sufficient for the purposes of this discussion to state that both of these new forms transfer the risk of changes in future experience levels to the policyowner. Thus, their pricing and risk characteristics are very similar, if not identical, to participating life insurance. Without question, the profit levels for these new forms do not remotely compare with the profit levels enjoyed by stock companies on their traditional nonparticipating individual policies.

Participating individual insurance is the most widely issued form of life insurance, and has been for a long time. The newer forms mentioned above are still in the developmental stages, but are so similar to participating insurance in their pricing and risk characteristics as to have no significant effect on consideration of an ownership differential. Therefore a comparison discussion based on participating insurance is appropriate.

The level playing field tax disadvantages of stock companies

It has been suggested that a stock company is at a disadvantage because shareholder dividends are paid from after tax dollars and policyowner dividends are deductible. No one has argued that an extra tax should be imposed on Mutuals simply because the stock company may allocate some of the earnings on the policyowners' money to the shareholder. Rather the focus is on a so-called tax disadvantage. It is instructive to examine the so-called tax disadvantage even though mutuals do not distribute equity earnings through dividends.

First consider a stock company that does not pay dividends to its shareholders (there are a number of such companies). When a shareholder of such a company sells his stocks, the gain, if any, is taxed as a capital gain. The policyowner of a mutual has no similar equity interest that he can sell. However, if he surrenders his contract for cash, or receives policy dividends in excess of the total premiums he has paid, these gains are taxed as ordinary income. Note that his premium payments have been included in the company's taxable underwriting income. On the other hand, contributions by shareholders to a stock company are not included in its taxable income. Even if some of a mutual policyowners' dividends have been part of the return on equity (which they are not!) it seems that he is at a disadvantage when compared to the shareholder of a stock company that does not pay current dividends to shareholders.

A question might be raised comparing the two on death. Neither life insurance proceeds nor appreciation on stock held by a decedent are subject to income tax. Both are included in the decedent's estate. There would appear to be no significant difference here.

As for the taxation of the companies, there is no difference with regard to retained earnings.

What if the stock company distributes some of the gain allocated to shareholders from participating policies? The stock company does indeed distribute dividends to shareholders out of after tax dollars. What will this amount to in terms of tax disadvantage? Many do not allocate the maximum permitted by law (witness the Aetna throughout most of its history allocating no earnings on par business to its shareholders). A few companies may not be subject to any legal limit and may allocate more than 10 percent of the gains. Frankly, we doubt that they want to serve themselves up as examples of how much of the par policyowners' money should be allocated to the shareholders. While there is no clear-cut norm, something less than 10 percent would be reasonable if calculations for instructive purposes were to be made. Further, of the earnings allocated, only a part is paid out. We are not aware of any company that consistently pays out all of the earnings allocated to shareholders.

Of the earnings paid out to shareholders a part is paid to holding companies which do not pay taxes on dividends received from subsidiaries. In turn, the holding companies may eventually pay some part of them out to their shareholders, to whom they may be taxable income. In addition, individual shareholders may not incur any tax because of the dividends received exclusion. Still other sharehohlders may be tax exempt investors.

Accordingly, a very large number of assumptions need to be made in order to quantify the net tax effect described. Any reasonable set of such assumptions would produce a very small number, indeed, when expressed in terms of an alleged "tax disadvantage".

If the actual "tax disadvantage" of a stock company issuing a similar product is so small, what is all of this fuss about? The stock companies are putting forward exaggerated theories based on apples and oranges comparisons while at the same time nearly all of the stock companies are switching to new products essentially similar to participating policies. However, these new products are nominally called "non-participating" and thus are *not* subject to the profit limitations and other requirements for equity imposed on participating policies.

The stocks want very much to maintain the level of profits they have enjoyed recently while at the same time changing to products which shift the risks to the policyowner. They know that the only way they can achieve that result is by having a massive penalty tax imposed on mutual companies. Their new products are simply too similar to participating policies to compete effectively and achieve the profit margin they desire unless a significant penalty tax is imposed on mutual companies.

A minimum tax

The clue to making some order out of all of this contention can be found in Mr. Chapoton's statement for Treasury. The Treasury would not suggest that the imputed "corporate profit" be added to the "corporate profit" actually reported by the mutual enterprise. Rather, Treasury's position is that the taxable income for a mutual life insurance company should not be less than its "corporate profit" and that one possible method for approximating corporate profit would be to compute capital and impute a return on this capital. The corporate profit so computed could be treated as a floor amount below which policyowner dividends could not reduce taxable income. Another more direct approach would be to impose a minimum tax base equal to "corporate profit".

As discussed earlier, in a stock company issuing participating insurance, only a part of the surplus represents the equity of the shareholders. The balance belongs to the participating policyowners. Thus, only a portion of the mutual surplus; if any, can be identified as the policyowners' equity in the enterprise as owners.

CONCLUSION

We do accept that there is any such quantifiable equity ownership in a mutual. As described elsewhere, the policyowner has no tangible claim on any such equity. Nevetheless it is an abstract concept that may aid in clarifying the alleged tax disadvantage of the stocks.

Also as described earlier, we are very troubled by the obvious tax disadvantage a mutual would have under any such imputation to tax to it in competition with a stock company that as a matter of practice does not make any significant cash distributions to it shareholders.

We also suggest that if some form of minimum tax base is needed for mutuals, a comparable minimum tax base should also apply to stock companies which issue participating insurance or other products, with post-issue price adjustments.

SUMMARY

We believe that it is both possible and desirable to develop a tax law for life insurance based on sound tax policies. We believe firmly that it is both possible and desirable to develop a tax law based on real economic income. With regard to the ownership differential issue, we believe there is no theoretical justification for such a tax differential. If an ownership differential is to be imposed, it should be based on the pragmatic and practical application of the corporate profit concept possibly in the form of a minimum tax base. Mutuals are uniquely consumer oriented. We simply do not have the conflict of interest between policyowners and shareholders that stocks have. The stocks proclaim that we (and thus consumers) should be penalized therefore.

We support strongly the statements made both by members of the Subcommittee and by Mr. Chapoton that the tax law should not be developed in order to produce a predetermined level of revenue. We are certainly aware of revenue needs. But we are even more aware of the change and trauma that the life insurance industry has been subjected to under the current volatile economic conditions.

We thank you very much for this opportunity to express our thoughts. We are more than willing to work with you in any way that can be helpful to you.

SUPPLEMENTARY COMMENTS ON ALLEGED EQUITY DISTRIBUTIONS BY MUTUALS AND THE NATURE OF DIVIDENDS TO POLICYOWNERS BY THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.

These comments are directed at the suggestion that mutual life insurance companies make distributions to policyholders that are economically similar to distributions to shareholders of stock life insurance companies. With careful definition of the question and analysis of the testimony of others, we believe we can show the members of the Subcommittee that there is no substantial disagreement between the apparently conflicting views presented to the Subcommittee at its hearings on May 10 and 11, 1983.

We think you will find it is extremely unlikely that any mutual life insurance company has made or will make any "equity distributions" to policyholders. If, however, there is concern that mutual companies may make such distributions, the rational way to respond to this concern is to define a minimum income tax base for such companies. Our people have some ideas on this matter and if there is interest we are prepared to work with Members and staff to perfect them. In any event, we believe you will also find, once we respond to the question presented, there is no fundamental disagreement among your witnesses on this subject.

There are a number of reasons why we cannot reduce our surplus levels or decide to pay out earnings on surplus. The most obvious reason is that to do so would reduce a company's economic size. Diseconomics of scale are not in our policyholder's best interest. Clearly the type of inflationary economy that we have had since the second World War requires one to run faster, not slower, to maintain economic size.

Over the last 20 years, our costs have dramatically increased. However, our policyholders are paying less per unit for insurance than 20 years ago because of improved mortality experience *and our ability to control unit costs.*

We are proud of our record in controlling costs. The key to our success has been to handle a large increase in business without a corresponding increase in cost. This, of course, requires a constant growth in business that persists.

Now returning to the assertion that mutual companies make equity distributions, recall earlier testimony. As Norma Nielson pointed out: ". . . longstanding theory calls for each policy in a mutual company to make a *permanent* contribution to surplus. This finances the acquisition of a new policy just as previous policyholders financed the early years of one's own policy." [1] (Emphasis added.)

Thus, as Ms. Nielson also pointed out, ". . . the 'equity distributions' of mutual insurance companies occurring in the dividend payouts of mutual insurance companies is insignificant and is not a major consideration in taxation." Or, as Professor Boskin put it in his testimony, ". . . it may not be worth the candle to attempt to define and measure 'equity ownership' in a mutual company" because "whatever equity policyholders might have in a mutual company is surely quite different from whatever equity they might have as embodied in common stock ownership."

Your life industry witnesses understand this point. However, there has been a tendency recently to assume that because policyholders are "owners", mutual companies *must* make shareholder-like distributions to policyholders. This perception is a relatively new one. Certainly it is no more than nine months old and it probably results from not properly defining the question.

No distribution to a policyholder can be the kind of distribution of property that is characterized as a dividend by the Internal Revenue Code. For those who want to refresh their recollection of why this is so, we have attached a brief explanation to this statement.

The question then is whether or not mutual companies make distributions to policyholders that are *economically similar* to distributions made by a stock company to its shareholders. The assertion is, that deductible distributions are made by mutual companies to "stockholders", stock companies have a tax disadvantage in that their distributions to stockholders are not deductible to the company. Worse yet, in some cases, the payments are taxable to the recipient.

Clearly there can be no tax disadvantage if a mutual company does not in fact make such distributions. If it retains all of the alleged "equity earnings" and does not distribute such earnings it is in precisely the same tax position as a stock company.

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[1] Ms. Nielson, you will recall, has a Ph.D. in insurance from the University of Pennsylvania and is presently Assistant Professor at the University of Southern California's School of Business. Ms. Nielson's discussion of equity distributions appears on pages 6-9 of her testimony.

We think earlier witnesses agreed by the substance of what they said, that this is a fair statement of the question. For instance, the Stock Information Group stated at one point that: ". . . from an economic standpoint, the policyholders of a mutal life insurance company are also its equity owners—its 'shareholders,' if you will. Thus, unlike excess interest, dividends paid by mutual life companies simultaneously operate to distribute corporate *profits* from the corporation to its *owners.*" (emphasis in the original).

Later after discussing ways to measure a return on equity ownership of a mutal life insurance company the Stock Information Group statement concludes: ". . . the objective is to estimate that portion of policyholder dividends that should be disallowed so that the resulting corporate level tax liability approximates the tax that would be imposed had the entity been investor-owned and the returns on its equity taxed as such."

The statement of the Treasury is similar: "We believe that a mutual company should be allowed to share investment and mortality gains with its policyholders to the extent that a stock company could share gains with its policyholders. However, to the extent that policyholder dividends represent a dividend-type return on equity, they should not be deductible.

The ACLI retained Professor Henry J. Aaron, who also testified before you, to consider how the equity earnings of a mutual company might be determined.[2]

As Professor Aaron observed to you:

"The problem is how to distinguish the portion of company income that is return to policyholders *as owners* the portion that is a return to them *as policyholders.* The latter portion should not be taxed at the company level, according to the argument presented in the preceding section. The former portion should be taxed at the company level.

"I know of no precise way by which to measure the 'profits' earned by mutual insurance companies. . . ."

In his paper for the ACLI, Professor Aaron examined three possible methods for identifying the "true" or "correct" earnings on equity of mutual companies.[3]

Professor Aaron was attempting to measure the result of mutual company operations against some theoretical norm. If mutual companies earn less than the theoretical norm, the difference might be evidence of earnings diverted to policyholders.

In his analysis for the ACLI, Professor Aaron used three methods to identify "true" or "correct" earnings on equity of mutual companies.

Professor Aaron identified the before-tax earnings of stock companies as annual statement "net gain from operations after dividends and before federal income taxes." This is an appropriate base to use in comparing the operations of stock and mutual life insurance companies. He then assumed that these earnings should be taxed at the corporate rate (putting aside any tax/book adjustments) and not subject to reduction for distributions to stockholders.

Under Professor Aaron's first method, if stock companies earn 10 percent on book value, we should assume that mutual companies would also earn 10 percent on book value. If similar mutual company financial statements show earnings on book value of only 8 percent there may be a basis for assuming that 2 percent of the earnings on book value were diverted to policyholders (i.e., deducted by the Company in computing financial statement earnings).

None of the three methods discussed by Professor Aaron developed evidence that mutual companies make stockholder-like distributions to their policyholders.

The average rate of return on book value for all stock companies who were ACLI members in 1979 was 24.65 percent. The rate of return for mutual company ACLI members was 29.77 percent. Thus with the before-tax-rate-of-return of mutuals in

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[2] The report, A Report: Taxation of Life Insurance Companies, presumably was the foundation for the Brookings Institution report cited in Professor Aaron's statement.

[3] In discussing Professor Aaron's methods, we do not mean to imply that we agree that because a policyholder is an "owner" for some purposes the economic relationship between mutual companies and policyholders is similar to the relationship between corporations and owners of commom stocks. Nor do we agree that there is any real difficulty in identifying our earnings on equity. We have an accounting system which reflects such earnings.

Unfortunately Professor Aaron's contribution to this discussion can be misleading if not considered carefully because he seems to also assume that corporate *earnings* are equal to *distributions* to stockholders. This is not true. If Professor Aaron had followed the logic of his own analysis and after having established possible ways for measuring any "equity return" for a mutual company, taken the next step, his contribution would have been more valuable. He failed to identify the equity earnings routinely included in the income base of a mutual company and thus suggest that equity earnings be added to reported income. He may have been incorrectly advised that absent such an addition, mutual companies would have no reported income.

1979 higher than that of stocks, Professor Aaron's first method clearly indicates lack of stockholder-like distributions from mutuals.

We note that Professor Aaron's second and third methods used in his ACLI study also demonstrates that, as a group, mutuals did not make stockholder-like distributions in 1978 and 1979.[4] Thus we cannot assume that distributions of earnings on equity are made by every mutual life insurance company. Use of the method described by Professor Aaron in his testimony (accumulate surplus multiplied by a moving average on the market rate of return on tax-exempt securities) would produce a far lower rate of return (6.39% in 1975) than the actual return of mutuals (29.77% in 1979).

If there is concern, justified or not, that mutual companies may make "equity distributions" to policyholders (i.e., distributing surplus or earnings on surplus as policyholder dividends), the response to this concern should be to impose some minimum income base. We should attempt to make sure that taxable income is not reduced to less than the earnings on equity of the enterprise. This is the Treasury's postition.

In his statement, Assistant Secretary of the Treasury Chapoton indicated that "it would seem appropriate to use the 'corporate profit' of a mutual life insurance company as the measure of the nondeductible portion of policyholder dividends. This profit cannot be measured directly. One possible method of approximating this profit would be to compute the capital of the mutual company that is supplied by its policyholders, and to impute a return on this captial." In concluding his remarks Mr. Chapoton listed as one of the principle features of the conceptual framework for the tax treatment of life insurance companies to be "a full deduction would be allowed for amounts credited to policyholders other than in their capacity of stockholders."

The Treasury does not, of course, suggest the imputed "corporate profit" of a mutual life insurance company be added to the "corporate profit" reported by the enterprise. The Treasury position is that the taxable income for a mutual life insurance company should not be less than its "corporate profit" and that one possible method for approximating corporate profit would be to compute capital and impute a return on this capital. This of course is similar to the approach suggested by Professor Aaron, when properly interpreted, and is similar to suggestions that have been made from time to time by mutual companies.

We agree that defining a minimum tax base is the way to prevent a mutual company from reducing its taxable income to less than its "corporate profit", this objective cannot be achieved by limiting the deductibility of policyholder dividends on some products. One such method would be to limit deductions for dividends to policyholders (i.e., all post-issue price reductions) on all products so that such deductions could reduce taxable income to less than "corporate profit". Another, more direct and simple, approach would be to impose a minimum tax base equal to "corporate profit". In addition to addressing the perceived problem directly, a minimum tax base has the tremendous simplification of not requiring a statutory definition of dividends.

The Subcommittee has heard ample testimony to demonstrate that favorable experience can be returned to policyholders in a variety of ways. The practice is not limited to traditional policyholder dividends. A life insurance company if it chooses to return favorable experience can reduce future premiums, increase benefits or reduce prior premiums.

DIVIDENDS TO POLICYHOLDERS ARE NOT DISTRIBUTIONS MADE BY A CORPORATION TO ITS SHAREHOLDERS

Absent any Code provisions to the contrary, a policyholder dividend would be deductible as an ordinary and necessary expense of the insurer under normal tax rules. Such a "dividend" represents an amount paid to a customer and the Code limitations relating to the deductibility of dividends paid to stockholders would not apply.[1]

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[4] The Stock Information Group also suggested that one way to tax the return on ownership equity would be to "estimate an 'owners' return on mutual life insurance company surplus based on the average magnitude of shareholder dividends paid by stock companies in relation to their surplus." This is a bold attempt to impose a tax on mutuals that would protect the current profit margins being enjoyed by the stock companies as they move toward U Life and other lower margin participating products. Thus it might be construed as an appeal for federally enforced restraint of trade. This approach does not deserve serious comment.

[1] The term "dividend"is defined in Code Section 316(a) to mean "any distribution of property made by a corporation to its shareholders" out of current or accumulated earnings and profits.

A dividend paid to a policyholder is, of necesssity, an item of expense because it is incurred in connection with the income producing operations of the business and not incurred in a "capital transaction". The purchase price of the instrument on which the "dividend" is paid is fully included in income (unlike the purchase price of a security issued by a corporation) and the "dividend" is simply a price adjustment.

The basic legal relationships (and the accounting treatment which reflects these relationships) involved in policyholder dividends are quite different from the legal relationships involved in distributions to stockholders even though the word "dividend"is used in describing both relationships. This difference is illustrated in those situations where a stockholder buys a participating life insurance policy from the company in which he is a stockholder. The nature of his legal right to receive a "dividend" as a policyholder is quite different from the nature of his right to a dividend as a stockholder and is quite similar (perhaps identical for all practical purposes) to the policyholder of a mutual company. The amount of dividends paid to policyholders may depend more on the attitude of management than on the type of organization of the corporation. The economic consequences of the company retaining income otherwise available to pay "dividends" is also quite different.

Although a mutual policyholder has some "ownership" interests which are similar to those of the stockholder (such as voting rights and certain rights on liquidation), the policyholder has no quantifiable economic equity interest in the mutual company. The interest cannot be sold. The interest cannot be exercised to liquidate the corporation and secure a share of its assets. Although the interest may be of some general long-term beneift in obtaining insurance at cost for the mutual policyholder from a viable economic entity, the policyholder has no specific, identifiable, economically quantifiable, future interest in the equity or surplus of a mutual company or the earnings of such equity or surplus.

Realistically a policyholder cannot expect to receive "dividends" out of retained earnings. Thus, except in a very indirect sense, if current revenue is retained by the life company, the policyholder has lost any measurable share of such revenue. The stockholder, however, is in an entirely different position since the primary determinant of the value of a stockholder's ownership interest in the corporation is corporate earnings. Earnings retained by a stock enterprise benefit stockholders directly whether or not paid out in the form of a dividend.

Mutual policyholders purchase policies with the expectation that the policyholder is joining a group to buy insurance at cost. The policyholder expects the company to wisely invest premiuns paid by the policyholder and the policyholder hopes to share in any excess earnings on the policyholder's premium and the premiums of similarly situated policyholders. The policyholder does not believe that this process involves the acquisition of any interest in the surplus of the company and the policyholder has no expectation of sharing in the earnings of other groups, past or present.

It is reasonably clear that amounts paid to a policyholder would not fit within the definition of the kind of "dividend" that is not deductible by an ordinary corporation. The purchase price of an equity interest in a stock corporation is not an income item for the period, nor is a distribution to stockholders deductible by the corporation. Not all corporate distributions are income to the stockholder but only those out of earnings and profits. Earnings and profits, of course, are defined to permit the deduction of all expenses.

All of the premiums paid by policyholders in a mutual company are included in income. No effort is made to isolate any portion of the premium as being similar to a captial transaction. Rebates to customers are a charge against the current year's operations and the profit of the enterprise is measured, in both stock and mutual companies, by the amount retained by the company for the year and added to surplus.

The value of the equity interest of the stockholder is not determined solely, or even primarily, by the amount of dividends distributed to the stockholder. Its value depends primarily upon anticipated future earning capacity of the enterpirse. A mutual company policyholder has no quantifiable interest in the future earnings of the corporation.

The distinctions here are probably easiest to see in connection with a stock insurance company selling participating business. In such a situation, deduction of amounts paid by the stock company as dividends to policyholders would be subject to the limitations contained in the code provisions relating to life insurance companies in determining gain from operations but such dividends would be deductible in determining earnings and profits.[2] amounts returned to customers would be considered to be an expense and would, under any conventional accounting system, be considered as a deduction in determining current income and would not be considered as being a distribution out of current or retained earnings and profits.

"The cost of paying dividends to policyholders is clearly a 'true expense.' "

There is no substantial economic difference between participating policyholders determined by the form of the organization of the insurance company. In neither case does the policyholder have any marketable interest in net worth of the company, or prospect of receiving it in a distribution. In neither case is there any distribution of net worth to policyholders not previously withheld from them.

Most authorities on life company taxation would not seriously contend that dividends to policyholders are, in fact, similar to distributions to stockholders, but some would, for other reasons, urge restrictions on the deductibility of dividends to policyholders for political or competitive purposes. In order to avoid continuation of a tax scheme which invites nonsubstantive changes for tax purposes, it is important to recognize that there is no sound economic reason why a company cannot be operated totally and completely for the benefit of policyholders and still have "stock" outstanding, nor does the stock have to be owned by a mutual life insurance company to achieve this result. Indeed a number of "stock" life insurance companies, including one prominent member of the Stock Information Group, are subsidiaries of mutual casualty companies or other forms of mutual or tax exempt enterprises.

ADDITIONAL STATEMENT OF THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.

SUMMARY

July 28, 1983.

In general

Generally, the proposal advanced by Subcommittee Chairman Stark and Congressman Moore (as described in a committee print pamphlet released on July 14, 1983, entitled "Description of Life Insurance Income Tax Proposal") constitutes a good faith effort to develop a rational income tax system for life insurance companies. The general conceptual framework would eliminate the serious defects of the 1959 Act. However, the formula chosen to implement an "ownership differential" provision unjustifiably imposes a severe competitive disadvantage upon mutual companies. Both the amount of the hypothetical equity base and the imputed rate of return used in the formula are substantially overstated. Thus, with the present formulation of the ownership differential proposal, the Northwestern Mutual cannot support the proposal.

Impact of the proposal on Northwestern

If the proposal had applied to the actual facts and circumstances of 1982, our regular tax liability would have been approximately $40 million (determined without regard to the ownership differential provision or any tax on the runoff from changing the tax reserve basis). However, the tax liability would have been increased to approximately $179 million by the ownership differential provision. The increase of $139 million is about 345 percent of the basic tax. The proposal would result in disallowing deductions for approximately 58 percent of dividends paid to policyholders.

If growth continues at the present level, results for 1984 are estimated to be comparable to 1982 except that tax liabilities would reflect growth actually experienced.

The proposed ownership differential would make it impossible for the Northwestern Mutual to survive in its present form. The effect of an ownership differential will be reflected in product pricing by both stock and mutual companies. An unjustifiably large differential will hurt the 44,000,000 consumers who own permanent insurance issued by Mutual companies and all future consumers as well as severely damage the mutual companies themselves.

RECOMMENDATIONS

1. Ownership differential

If an ownership differential is to be determined on the basis of a return on equity and operate as a limitation on the deductibility of policyholder dividends, we recommend that the equity base should essentially consist of a company's statutory surplus and that the rate of return reflect the actual investment experience of the particular company subject to the provision. Specifically, a liability for policyholder dividends should not be reclassified as equity. Neither should reserves. No hypothetical imputed rate of return should be used, particularly one that is totally unrelated to the insurance industry (such as the rate of return earned by the top 400 industrial corporations).

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[2] *Luckman* v. *Commissioner of Internal Revenue,* 418 F.2d 381, 384 (7th Cir. 1969), held that ". . . true expenses incurred by the corporation reduce earnings and profits despite their nondeductibility from current income for tax purposes.

"The cost of paying dividends to policyholders is clearly a 'True expense.' "

Finally, adjustments to the amount determined as an "equity return" should be allowed to preserve tax-favored treatment for tax-exempt interest income, corporate dividends received, long-term capital gains, and similar items.

2. Stock subsidiaries of mutual companies

An ownership differential designed for mutual companies should not apply to a stock subsidiary of a mutual life insurance company.

3. Treatment of policyholders

The present tax treatment of policyholders should not be changed but rather any perceived abuses should be addressed by formulating a better definition of life insurance.

4. Treatment of reserves

A life insurance company should be permitted to calculate reserves for income tax purposes under the Commissioners Reserve Valuation Method (CRVM), rather than under the minimum State law reserves proposed, with a cash value floor. Further, a "fresh start" restatement of reserves under any new method should be allowed, rather than taking any change in basis into account pro rata over ten years. At the very least, a tax benefit limitation should apply if the reserve differences are taken into income over a period of time.

IN CONCLUSION

Attached is a more detailed commentary. These comments have been quite brief, because of time constraints. We would be more than pleased to discuss and elaborate any points we failed to make clear, or which you would like to pursue in more detail. We believe that you (and we) are on the track of a sound and fair tax basis for life insurance companies for the long term. Thank you for receiving and considering our comments.

STATEMENT

This statement will contain our comments on certain provisions of a proposal advanced by Subcommittee Chairman Stark and Congressman Moore. That proposal was described in a committee print pamphlet released by the Subcommittee on July 14, 1983, and entitled "Description of Life Insurance Income Tax Proposal". Our comments will include a general introduction, an estimate of the impact of the proposal on this company and comments on certain provisions of the proposal. Some sections not commented on here also need modification, but those modifications will be adequately addressed by others.

General introduction

We acknowledge the proposal as a good faith effort to develop a rational tax system for life insurance companies. The general conceptual framework would eliminate the serious flaws of the 1959 Act. However, we believe that the ownership differential provision is very seriously flawed in its detailed implementation. Thus, with the present formulation of that provision, the Northwestern Mutual cannot support the proposal.

Impact on the Northwestern

We have made careful initial estimates of the impact of the proposal on the Northwestern Mutual for the year 1982 because it is the lastest year for which actual data is available. There were a few minor anomalies in our 1982 results, but it is a reasonable basis for examining the proposal. The gain from operations after dividends in 1982, was a little lower than our normal pattern, but even so it represented a rate of return on surplus considerably larger than the company's portfolio rate of return on assets. If growth continues at the present level, 1984 results will be comparable, but will reflect the actual growth experienced.

Taking into account all of the features of the proposal except the "Ownership Differential" and any possible tax on the runoff from changing the tax reserve basis, our 1982 tax would have been about $40.4 million. However, if the ownership differential provision is reflected in our calculations, our tax would have been about $179.8 million. That $139 million increase is about 345 percent of the basic tax and represents a disallowance of about 58 percent of our policyholder dividends.

Under the proposal, the increased tax burden arises solely because of the form of entity used to conduct business, i.e., business conducted by a mutual life insurance company rather than a stock company. The proposed ownership differential would make it impossible for the Northwestern Mutual to survive in its present form. The effect of an ownership differential will be reflected in product pricing by both stock and mutual companies. An unjustifiably large differential will hurt the 44,000,000 consumers who own permanent insurance issued by Mutual companies and all future consumers as well as severely damage the mutual companies themselves.

Some analysis of why this totally unacceptable difference developed and some suggestions for bringing it down to a reasonable level will be given in the section of these comments relating to ownership differential.

Single phase tax structure

We fully agree that a single phase tax system is the proper basis. However, because of the serious flaws in the ownership differential, that goal has simply not been achieved in this proposal for mutual companies. It is possible that a very small number of mutual companies may be taxed on Gain From Operations after deducting 100% of dividends. Most mutual companies will be taxed on the artificial and arbitrary imputed yield on defined equity. Finally, some mutual companies will be taxed on Gain From Operations before deducting any dividends. That looks like a new three-phase system to us. Thus, the implementation of the ownership differential defeats achieving the meritorious objective of formulating a single phase tax system.

Ownership differential

There are serious flaws in both the equity base and rate of return used to implement the proposed Ownership Differential. The definition of the so-called "policyholder's investment in the company" includes significant amounts that simply cannot properly be identified as "owner's equity", and the imputed yield on this hypothetical "equity" is grossly overstated. The following paragraphs will discuss the flaws and suggest corrections.

Equity Base.—With regard to the "equity", the dividend liability included is clearly identified as a liability by the accounting theories and methodologies with which we are familiar. It must be treated as a liability under the requirements of state law. This proposal so treats the dividend liability in determining taxable income under the basic rule but inconsistently identifies it as equity in calculating the ownership differential. This liability represents the setting aside of the "distributable earning" of the current calendar year for distribution to policyholders on their policy anniversaries during the following calendar year. If less than the full dividend will be paid under certain circumstances, that is taken into account in establishing the liability. Thus, the amount represents actual commitments to pay affirmed by formal Board action. That's a liability.

The Mandatory Security Valuation Reserve is established to accommodate the carrying of certain equity investments at market and to provide a reserve for certain fixed income security losses. These are necessary and appropriate in calendar year accounting in life insurance, which is largely comprised of very long fixed-dollar commitments. Such reserves are much more properly identified as liabilities rather than equity.

The reference to "any non-admitted financial (investment) assets" in the Description needs clarification. We have assumed that it means that only those non-admitted assets that are of investment quality are to be included. We assume that it is not intended to include such questionable items as bonds in default.

If an equity base is to be defined, it should not include any items other than statutory surplus and the appropriate part of non-admitted assets.

Rate of return.—In the proposal, the imputed yield on this hypothetical "Equity" appears to be a moving average of three rates; the acutal observed stock life insurance companies' rate of return on equity (similarly defined), the rate of return earned by the top 400 industrial corporations, and the rate of return on one-year Treasury bills (grossed up by the corporate rate).

The current earnings of stock life insurance companies are in significant measure coming from blocks of non-participating life insurance. This is a profit center which is unavailable to Mutual Companies because most jurisdictions prohibit Mutuals from writing non-par cash value life insurance.

Non-par carries significant risk to the company, and thus has throughout history been identified as carrying larger profit margins (and thus a larger rate of return than participating business). Also, the last thirty years have been characterized by almost continuously increasing interest rates which have produced very large profits on non-par in excess of expected profits. There is *no* justification for imputing to mutuals the naturally larger and currently inflated profits being enjoyed by stock companies on their blocks of non-part business.

If one feels that it is necessary to base the taxation of mutuals on the results obtained by stocks the proper basis of earnings has to be comparable. The most analogous basis would be the stock companies rate of return on participating business. This is particularly impotant in that currently stock companies are very largely shifting from non-par products to de-facto participating products. A tax law sensitive to economic realities cannot ignore this significant shift in profit basis. It is also significant to note that if a stock company issues participating business several key jurisdictions require a strict separation of accounts and limit the profits that may be allocated to shareholder. This results in only a portion of surplus being identified as belonging to shareholders; the balance belongs to the policyholders. Thus, if a proper stock model were used, the yield on equity would be considerably lower than the current observed yield of stock companies. Not only that, but the equity base would be less than statutory surplus.

We are not aware of any possible rationale for imputing to mutuals the current rate of return of the top 400 industrial corporations.

We also don't know what rationale there is for including the one-year T-bill rate. As for the grossing of it up, presumably by dividing it by .54 (one minus the top corporate tax rate of 46 percent), perhaps this is based on the assumption that all stock life insurance company earnings are distributed to shareholders. Of course, this is not true; only a portion of earnings are distributed (some stock life insurance companies retain all earnings as a matter of policy). There is no difference in taxation of retained earnings between stock and mutual life insurance companies. Thus, if there is ever a reason for "grossing up", it should only reflect the actual earnings distributed, not all earnings.

Finally, actual rates of return vary significantly among mutuals. What rationale is there for imposing a single uniform imputed rate on them, however determined? Why shouldn't that rate (if this conceptual framework is to be used) be the individual mutual company's actual rate of return as reported in its financial statement?

It could be argued that the company's portfolio rate isn't a measure of "return on equity". On the other hand, participating life insurance is an exceedingly low-risk venture.

Why should the policyholder's return on his very low-risk equity (if there is any such return), be any higher than the return on his policy value? After all, if the allegation that there is such a return on equity through dividends is valid, then there is only one interest rate involved—the dividend interest rate. That rate is derived directly and precisely from the company's portfolio rate. Furthermore, the interest component of the dividend is calculated by multiplying that rate by the policy's cash value or reserve. Where is there any "equity return" to the policyholder in that?

In summary, even if any validity is granted to this Ownership Differential concept, the definition of "Equity" is seriously overstated, and the imputed yield suggested has no sustainable rationale behind it. If the concept is to be implemented at all, the defined equity should be limited to statutory surplus, plus some part of Non-admitted Assets, and the imputed yield should not exceed the mutual company's own portfolio rate.

Finally, adjustments to the amount determined as an "equity return" should be allowed to preserve tax-favored treatment for tax-exempt interest income, corporate dividends received, long-term capital gains, and similar items.

Stock subsidiaries

If the ownership differential is not excessive, there is no tax policy reason for this provision. If the ownership differential is excessive, then fair tax policy would argue that this provision should not be present. Either it isn't needed, or it shouldn't unfairly prevent an overtaxed mutual from reaching a fair tax basis. How can it be argued that a policyholder of a stock subsidiary has any "equity ownership" in his company?

Investment oriented contracts

In the last few years, two kinds of life insurance contracts have gained some prominence that are considered by some to be abusive of the favored tax treatment granted to life insurance policies under certain circumstances. One type is designed to minimize the death protection element and emphasize the investment accumulation feature. The second type also minimizes the death protection element, but also features maximum policy borrowing within the safe harbor guidelines.

Our position is that the most effective way to deal with these perceived problems is through a tight definition of life insurance, without any change in the present borrowing limitations. There are so many different non-abusive and socially desirable uses for the policy loan provision that it would be very difficult (indeed probably impossible) to deal with the perceived abuses through more restrictive policy loan restrictions, without seriously impairing quite legitimate uses of the policy loan provision.

Treatment of reserves

The basic tax reserve basis in the proposal has two features that would impose administrative costs and implementation problems far out of proportion to their revenue potential. These comments pertain to individual insurance. Northwestern does not write group insurance and group annuities. Comparable amplification for those areas should come from people familiar with them. For individual insurance, the two problems are (1) the use of minimum state law reserves, and (2) the requirement that tax reserves be on "(1) a full preliminary term method . . ., (2) the highest assumed interest rate permitted under State law, and (3) the most recent mortality table allowed under State law . . . at the time the contract is issued in the State in which the contract is issued."

The problems have to do with many minor variations in state laws, different effective dates and the very difficult systems, implementation and audit problems that would result.

A much more effective approach would be to require that Commissioners Reserve Valuation Method reserves calculated using the interest rate and mortality table used by the company for each contract with a cash value floor be the tax basis reserves. There would still remain some reserve method definition problems, but systems, implementation and audit problems would be minimized. Revenue would only be modestly affected by this much simpler approach. At the very least, the proposal reserve basis should not be adopted without study and revenue loss estimates of our suggested mush simpler approach.

The reserve basis should also be clarified to permit appropriate reserves for certain level premium contracts and ancillary benefits that do not provide cash values. Disabiltiy income insurance, waiver of premium provisions and accidental death benefits are examples.

Company taxation

Here we simply want to state that the differences between the new basis reserves and the old basis reserves as of January 1, 1984, should not "be taken into account pro rata over ten years". There is amply precedent for this fresh start approach. It is also true that many companies had very little tax benefit from the previous reserve basis because of the Phase System of the old law. A tax benefit limitation is necessary if any reserve differences are to be taken into income over a period of time.

NORTHWESTERN NATIONAL LIFE INSURANCE CO.,
Minneapolis, Minn., May 18, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, House of Representatives, Washington, D.C.

DEAR CHAIRMAN STARK: I am writing on behalf of Northwestern National Life regarding the need to eliminate double taxation imposed by existing law on dividends from our wholly-owned subsidiaries.

Northwestern National Life Insurance Company is a combined stock and mutual life insurance company, organized under Minnesota law and doing business, directly and through subsidiaries, throughout the United States. Northwestern National has subsidiary companies in the life insurance, reinsurance, property and liability insurance, and other financial services businesses. Our ownership (i.e., combined stock and mutual) does not lend itself to the "upstream holding company" structure that has characterized some company organization. Accordingly, Northwestern National Life, which itself is a life insurance company taxed in accordance with the 1969 Tax Act, is the parent of these subsidiaries.

A number of other companies, both stock and mutual, are also concerned with this problem.

The double taxation of our intercorporate dividends results from the proration scheme of the 1959 Tax Act. A subsidiary, of course, pays the regular corporate tax based on its particular tax status on its taxable income. Then a second tax burden is imposed because the dividends it pays to Northwestern National are prorated and thus are not fully excluded from income, as they are in the case of other corporations. In my Company, the second tax would amount to approximately 25 percent of the dividends from wholly-owned subsidiaries.

A number of insurers have been able to avoid this result by becoming subsidiaries of holding companies, an arrangement not available to mutual companies, or to a company, such as my Company, that operates with both a stock and mutual department. Moreover, some stock insurers for business reasons prefer not to become subsidiaries of holding companies. Accordingly, some companies have been able to avoid this second corporate tax, others have not.

In the development of a new life insurance company tax act, we hope that your Subcommittee will correct this inequity. Both stock and mutual life insurance companies have been opposed to the proration rule of the 1959 Act, and one approach in the development of a new tax act would be the complete elimination of the proration rule. Other financial institutions are not penalized as the life insurance industry is by such a rule and we feel your Subcommittee should eliminate this discriminatory tax treatment. Such action would, or course, solve the double taxation of dividends from our subsidiaries.

If it is decided to continue the proration scheme of the 1959 Act, I recommend that dividends paid by a wholly-owned subsidiary to its life insurance company parent be excluded from proration. This would remove an unfair aspect of the 1959 Act and would contribute to the Subcommittee's laudable goal of creating a level playing field for life insurance company competitors. I believe that the other companies which share this problem with us will support this change.

At the appropriate time, we will be happy to discuss this matter with you and your staff.

Sincerely,

JOHN E. PEARSON,
Chairman and Chief Executive Officer.

THE OHIO NATIONAL LIFE INSURANCE CO.,
Cincinnati, Ohio, July 27, 1983.

Re proposal dated July 14, 1983, by the subcommittee on select revenue measures regarding the tax treatment of life insurance companies and their products.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: We appreciate this opportunity to express our views on the Subcommittee's tax reform proposal. Please enter this letter in the record of the Subcommittee's proceedings.

The Ohio National Life Insurance Company is a mutual life insurance company headquartered in Cincinnati, Ohio, with assets of $900 million. The company has been in business since 1909 and now operates in 39 states and the District of Columbia. The company also has a wholly owned stock life insurance subsidiary, Ohio National Life Assurance Corporation, formed in 1979. The subsidiary now has assets of $18 million and does business in all but two of the states in which the parent operates.

Our companies sincerely applaud the efforts of the Subcommittee to draft new tax legislation affecting the life insurance industry which can hopefully be adopted and placed in effect when the current stop-gap legislation expires. We recognize that substantial time and effort has been devoted to receiving and evaluating testimony from the various segments of the life insurance industry and from other interested experts, and we believe that the Subcommittee has attempted to create a new approach which will achieve a higher degree of tax equity and adhere more closely to basic tax principles than the now ill-fated 1959 Act.

Specifically, we believe that the "single-phase" tax approach embodied in the Subcommittee's proposal is a major step in the right direction towards achieving a tax system for life insurance companies which bases tax liability on total economic income and not on different segments of the whole. In this respect, the proposal is certainly much simpler than the 1959 Act and offers all life insurance companies an opportunity to know with greater certainty how they will be taxed and to plan accordingly. The proposal eliminates the controversial expense allocation issues which have caused so much trouble for both stock and mutual life insurance companies and for the IRS in resolving appropriate tax liabilities under the 1959 Act. In short, progress towards making the impact of taxation a true reflection of economic income allows the tax laws to be more understandable and should allow the managements of both stock and mutual companies to price their products, develop their markets, and invest their assets without tax-driven distortions.

We believe that a key objective of new tax legislation should be to produce equity between stock and mutual life insurance companies so that they can compete with each other on a fair and equal footing without regard to the form of their organizational structure (stock vs. mutual). We also believe that life insurance companies, both stock and mutual, should be taxed fairly when compared with other financial institutions with which they compete in the financial market place. Finally, the level of taxes paid by life insurance companies should be fair when compared with the tax levels paid by commercial enterprises generally. In this respect, we believe that taxing true economic income is the only way to achieve all of these aspects of fairness and equity.

For the reasons set forth in the Mutual Company Statement submitted to the Subcommittee on May 10, 1983, we do not believe that a sound, theoretical basis exists for imputing an ownership differential tax on mutual life insurance companies. A mutual company's surplus is derived from premium income which is included in the company's taxable income base and from retained earnings which have also been taxed. Contributions to the capital accounts of stock life insurance companies may derive in part from paid-in capital which is not received as taxable income, and from retained earnings as well. Moreover, even if an ownership differential might be said to exist, we believe that the Subcommittee's proposed method for measuring that differential produces unduly harsh and unintended results.

We are also concerned in principle with the proposed 25 percent deduction which has no other apparent basis than to achieve a desired revenue level. The 1959 Act, with its three phases and its artificial deductions, floundered on a tax law structured in such a way. In the case of mutual companies, if the "ownership differential" is more appropriately determined and if reserve deductions are properly allowed, the 25 percent revenue adjustment deduction should not be necessary. The very need for such a deduction suggests that some part of the earlier tax structure established by the Subcommittee's proposal is essentially flawed.

In a sense, while not intended, the Subcommittee's proposal would re-create a multiple phase tax structure. As a practical matter, most mutual companies would be required to pay tax on their imputed return on equity less the 25 percent general education. The rest of the tax computation would be meaningless paperwork. Stock companies would pay tax on their net economic incomes after having deducted 100 percent of the dividends (or excess interest or premium adjustments) paid or credited to their policyholders, less the 25 percent deduction The law would thus encourage mutual companies to search out creative ways to reduce their surplus (contrary both to the desires of state insurance regulators and to the genuine security interests of policyholders), with the hope of reducing their return on equity to the point that all or a significant portion of their dividends to policyholders could be deducted from their economic incomes.

Under the 1959 Act, we understand that a number of large stock life insurance companies were taxed in "Phase I". Thus, they were taxed essentially the same as mutual life insurance companies. These stock companies typically had sold a fair amount of participating insurance policies (dividend-paying) as well as non-participating plans. Under the Subcommittee's proposal, all forms of excess interest or premium adjustments will be treated as dividends to policyholders, so that stock companies, in effect, will continue to sell participating policies. Taking the stock company that had been taxed in Phase I under the 1959 Act and a similarly situated mutual life insurance company, what would be the result under the Subcommittee's proposal? The stock life insurance company will be taxed on its economic income after fully deducting its "dividends" to policyholders, and then being allowed a 25 percent general deduction. The mutual life insurance company, on the other hand, will be restricted in its ability to deduct its dividends to policyholders by the proposed ownership differential rule. Depending on the company, that restriction on dividend deductibility might well be 50 percent or more of the mutual company's dividends. Thus, the new law would not be tax-neutral with respect to similar products designed and priced by two essentially similar companies, one being stock and one being mutual.

As a final general comment, we would object to the use of the 1959 Act level of taxation as a target for the level of taxation to be achieved under the new law. We believe the Subcommittee has received credible testimony from a number of witnesses pointing to the unfairly high level of taxation which the 1959 Act generates under current economic conditions. Under the 1959 Act, the level of taxes paid by the life insurance industry in proportion to total corporate taxes and in comparison with the taxes paid by other financial institutions increased dramatically up until 1979. Only the beneficial tax effects derived from modified coinsurance transactions (since eliminated by TEFRA) offered any relief. The Subcommittee's proposal aims at achieving a revenue level slightly below that which would be achieved if the 1959 Act were allowed to continue in effect without extension of the current stop-gap provisions. In the case of our companies, disregarding unusual transactions and depending upon the correctness of our interpretation of the Subcommittee's proposal, we would expect to pay taxes at least 3 percent higher (and possibly much more) than what we would otherwise have been required to pay beginning in 1984 under the post-stop-gap 1959 Act. Thus, while we favor tax reform at this time and favor the general direction which the Subcommittee has taken in its proposal, the actual financial results of the ownership differential feature are so severe as to cause us to prefer no change in the tax law at all if this is to be the result.

Our specific comments, questions or concerns are as follows:

1. Ownership Differential.—The ownership differential provision assumes that a mutual life insurance company will earn a pre-tax rate of 23 percent on its capital account (surplus). This assumption is clearly unfounded, in our view, for the following reasons:

(a) A pre-tax rate of 23 percent could possibly be a fair rate when applied to the market value of assets productively put to use in a commercial enterprise. A mutual life insurance company's assets and liabilities are determined, however, under statutory accounting rules. The bulk of an insurance company's assets are carried at book value under statutory accounting rules without adjusting for changes in market value. If that portion of the assets of a mutual life insurance company equal to its surplus is to be hypothetically isolated for purposes of imputing a rate of return, then certainly those assets should be adjusted to market value or the rate of return should be adjusted. Assuming that a market value adjustment to 75 percent of book value might be in order, for example, an equity base of $100 million would reduce to $75 million or a 23 percent rate would reduce to 17¼ percent when applied to book value.

(b) It is also incorrect, in our view, to assume that all of a mutual life insurance company's surplus is available for or actually used for venture or growth purposes as opposed to added safety. In fact, surplus is largely held to provide an extra margin of protection or safety for policyholders, over and above the minimum reserve levels required by state law, in order to guard against unforeseen contingencies which may affect the company's ability to meet its contractual obligations. These funds are not invested in acquiring new policies, developing new products or otherwise financing growth and expansion. To the contrary, these assets are passively invested in bonds and mortgages and other relatively secure investments which do not earn anywhere near the 23 percent pre-tax rate assumed in the Subcommittee's ownership differential adjustment. A more appropriate rate to assume would be the pre-tax portfolio rate for life insurance companies, which currently averages just under 9 percent.

Thus, if indeed an ownership differential is to be recognized, it is certainly not correct to calculate the rate of return at 23 percent. Clearly, a rate adjusted to reflect the market value of the company's assets would be required with respect to that portion of the surplus which might be considered as business opportunity surplus, while a current rate in the neighborhood of 9 percent would be more appropriate for the bulk of a company's surplus which is maintained as an added measure of financial security for the benefit of its policyholders.

Secondly, and perhaps of greater significance, if mutual life insurance companies are to be denied a deduction for dividends to the extent of imputed income on retained earnings, then the same rule should apply to stock life insurance companies with respect to their "dividends" (or excess interest payments or premium adjustments) to their policyholders stemming from the same source. Since the aim of the Subcommittee's proposal is to properly reflect the economic income of both stock and mutual life insurance companies, the assumption appears to be that stock companies earn 23 percent on their capital accounts and distribute those earnings in the form of dividends to stockholders or retain them for the sole benefit of stockholders. It would appear to us that the earnings of stock companies are at least as likely to be retained as they are in the case of mutual companies for providing added financial backing for policyholder liabilities as well as for investment in the business. Obviously, then, it would be unfair to disallow a deduction to mutual life insurance companies for dividends distributed to their policyholders on the basis that a 23 percent rate of return on surplus is supposedly earned in the first place and that all of those earnings are included in the current dividends distributed to policyholders. Such a proposal is particularly unfair under circumstances where the purported "capital" contributed by mutual company policyholders is included in the income base of the mutual company, but capital contributed to a stock company is not included in its income base.

It would seem to us that a fairer way to determine any "ownership" differential would be to take actual stock dividends paid to the stockholders of stock companies as a percentage of their capital accounts and then apply that percentage to the capital accounts of mutual life insurance companies determined in the same way as for the stock life insurance companies. As a refinement, if desired, stock and mutual companies could be broken down into size categories so that mutual companies of a certain size would have the same imputed dividend return on equity as the actual dividend return on equity of stock companies of that size. Use of a three-year moving average might also be considered.

The concern of stock companies, as we understand it, is that mutual companies will have a product-pricing advantage if mutual companies are able to deduct 100 percent of their dividends to policyholders, since stock companies must make nondeductible dividend distributions to their stockholders as well as paying dividends to their policyholders or making other adjustments in the price of their products. Therefore, the only fair basis for eliminating any such perceived inequity would be to actually measure stock company dividends to stockholders as a percentage of their capital accounts, and apply that factor to the capital accounts of mutual companies. This would develop an amount of dividends to be disallowed mutual companies as representing the ownership differential.

In all respects other than the "dividend" issue, the operations of stock and mutual companies are essentially similar. The alternative we have suggested would thus appear to treat all companies alike, both stocks and mutuals, with respect to retained earnings. There should be no advantage, from a product pricing standpoint, to operating as a stock or mutual company. Mutuals would be denied a deduction for dividends paid to policyholders which represent the same percentage of their capital accounts as would apply in the case of stock company dividends to stockholders. Furthermore, mutual companies would not be discouraged by the tax law from holding appropriate levels of surplus for the protection of policyholders or as a source of capital for future business growth.

Significantly, we believe, state regulators would be greatly interested in having mutual companies retain adequate surplus levels for safety purposes.

If the Subcommittee's proposal as currently drafted with respect to the purported ownership differential were to be adopted, mutual companies would indeed be discouraged from holding surplus. Due to tax considerations, it would be extremely expensive for a mutual company to hold surplus for any reason. The Subcommittee's proposal as now structured would allow two very similar companies, one stock and one mutual, to price their products quite differently, with a significant advantage in favor of the stock company. The stock company would deduct dividends to policyholders 100 percent, while the mutual company would be severely limited in the availability of its dividend deduction.

2. Reserve Valuation.—As set forth in the Mutual Company Statement presented to the Subcommittee on May 10, 1983, we believe that reserves established under state law should be adopted as the standard for federal income tax purposes. If there are legitimate concerns about possibly overstating reserves in certain cases, we believe these should be addressed with narrowly targeted measures rather than by abandoning the state law standard altogether.

In accomplishing the transition to a new basis for tax reserves, we believe that any difference between a company's tax reserves under proposed new rules and those under present law should be eliminated from the determination of taxable income. The Subcommittee's proposal that such differences (which will almost always result in tax reserve decreases) be included pro rata in taxable income over ten years appears to assume that companies have previously benefited from the reserve increments, so that those increments should be taken back into income at the rate of 10 percent per year for ten years. However, in the case of insurance companies, both stock and mutual, which were taxed under Phase I of the 1959 Act, the increase in reserves did not result in a deduction for the companies. Only the deduction for required interest on the reserves produced a benefical tax effect. Thus, to recapture the reserve differential itself at 10 Percent a year would be to bring back into the income of many life insurance companies items that were not previously deducted.

3. Stock Subsidiaries of Mutual Life Insurance Companies.—We see absolutely no reason or need, in principle or in practice, for a provision in the tax law to treat the stock subsidiary of a mutual life insurance company as if it were in fact a mutual company. We assume that the Subcommittee's proposal with regard to mutual company subsidiaries is aimed at preventing mutual life insurance companies from using stock subsidiaries to make fully deductible dividend payments to policyholders. The very existence of this provision in the Subcommittee's proposal seems to acknowledge that operating as a stock company will be more advantageous under the proposed law than operating as a mutual company from a tax standpoint. Otherwise, the provision would not be needed.

4. 25 percent Overall Deduction.—As previously noted, we think that the 25 percent taxable income adjustment would be unnecessary in the case of mutual life insurance companies if the "ownership differential" were properly determined at a level that would allow for reasonable deduction of policyholder dividends and if reserve deductions were properly determined. Any kind of artificial deduction such as the proposed 25 percent deduction does not appear to offer a sound basis for inclusion in a permanent tax-law revision.

5. Tax-Exempt Income.—We are not sure that we understand the Subcommittee's proposal with regard to tax-exempt income. Apparently, the Subcommittee intends to continue the provisions of the 1959 Act which, in effect, prevent an insurance company from obtaining the full benefits of tax-exempt income. We believe the provisions of the 1959 Act are clearly erroneous in this regard and place life insurance companies at a disadvantage when acquiring tax-exempt securities. Is it not enough that the income received from tax-exempt investments is less to begin with than for taxable investments? If Congress desires to restrict the availability of the benefits which might be derived from the acquisition of tax-exempt securities, then it ought to do so for all investors and not just for life insurance companies. Otherwise, life insurance companies will continue to be inhibited from investing in tax-exempt securities, and Congress' overall purpose in encouraging such investment will continue to be subverted.

6. Pension Dividends.—We are extremely concerned that we find no provision in the Subcommittee's proposal for 100% deductibility of pension dividends by mutual life insurance companies. Clearly the Subcommittee's proposal would put mutual life insurance companies at a distinct disadvantage in competing for pension business if this oversight is not corrected. We would be at a disadvantage not only in comparison with stock life insurance companies but compared with all other financial institutions as well.

7. Product Taxation.—Testimony submitted to the Subcommittee by the Honorable John E. Chapoton, Assistant Treasury Secretary for Tax Policy, on May 10, 1983, indicated that it was not the Government's desire to overturn the traditional tax treatment of whole life insurance policies which were purchased and maintained for genuine insurance purposes. The Treasury Department did express concern about possible abuses in the design of life insurance products which may change the nature of these products from their essential role of providing life insurance protection to one of pure investment. The Subcommittee's proposal, we believe, goes too far in attempting to correct the alleged abuses identified by the Treasury Department. The Treasury Department had suggested several possibilities for dealing with their concerns. One would be a more restrictive definition of life insurance. Another would be to change the tax basis of life insurance upon surrender or cash withdrawal. Mr. Chapoton notes that:

"The treatment of investment income bears an important relationship to the definition of life insurance. To the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the investment income under policies that fall within that definition. Conversely, if a looser definition is adopted, it seems appropriate to place some limits on the tax free accrual of investment income in order to prevent savings through life insurance from obtaining an unfair advantage over other forms of savings."

It appears that the Subcommittee has chosen to adopt both a more restrictive definition of life insurance and, at the same time, provisions designed to change the tax basis of life insurance policies upon surrender or other cash withdrawal. If the definition of life insurance is revised to eliminate pure investment-type plans, then we believe that no need should exist to change the existing tax law on distributions from traditional forms of insurance.

Traditional whole life insurance policies, and their contemporary counterparts structured as flexible premium contracts or adjustable contracts, are still significantly different from savings accounts or other cash accumulation investments. In order to obtain cash values from a life insurance policy, the policyholder must surrender important rights in the contract. In this respect, ownership of a life insurance policy is more like ownership of an appreciating asset than ownership of a demand account. Gain on an appreciating asset is not taxed until the time of sale or exchange, and then a capital gains tax may apply to recognize the length of time over which the appreciation has occurred. The Subcommittee's proposal would reduce the tax basis in a life insurance policy by imputed, cumulative term insurance costs. However, if a policy has indeed been purchased for life insurance purposes, as opposed to pure investment purposes, then it will likely be surrendered (or another form of cash withdrawal will be made) only in the event of a financial emergency or in the event that the policy no longer serves the policyholder's needs. The Subcommittee's proposal would increase the incidence of tax on surrender as compared to present law, particularly with respect to insurance maintained over a long period of time or kept in force at older ages, with the result that older longstanding policyholders will be penalized for cancelling or withdrawing cash from their policies in times of need. Furthermore, if the policyholder had previously borrowed against the cash value of the policy, it is quite possible that the taxable gain at surrender would exceed the remaining value in the contract. Thus, the policyholder might incur a tax without having the corresponding funds available to pay the tax at that time.

The vast majority of permanent life insurance policies are purchased for very valid family or business insurance protection purposes. The Subcommittee's proposal would discourage the purchase of whole life insurance as a form of insurance protection. Lapsation and other studies affecting term insurance clearly indicate that term insurance protection is less likely to remain in force to provide actual death benefit payments to beneficiaries than permanent forms of insurance. Thus, the practical effect of the Subcommittee's proposal in this regard would be to cause life insurance protection generally to decline and to leave the public with lesser amounts of coverage than might otherwise be desirable.

We believe the members of the Subcommittee should carefully consider the ramifications of their proposal with respect to the impact it would have on insurance policyowners, prospective purchasers and agents within their own districts. The disparity that would be created between old policies and new policies is also a very significant factor. It does not appear that a fundamental change such as the one proposed should be undertaken without very careful analysis and thorough consideration. If there are abuses involving single premium life insurance policies, increasing death benefit policies or other forms of coverage identified by the Treasury Department as disguised investments, would it not be better to attempt to remedy the problem first through a redefinition of life insurance for tax purposes? If the abuses are thereby corrected, the traditional tax treatment of life insurance can remain in effect to help achieve the very desirable social ends which permanent life insurance so clearly satisfies.

We also believe that the proposed $50,000 limit on policy loans is completely arbitrary and should not be necessary if life insurance is properly defined to eliminate policies that are essentially investment vehicles in disguise. Any such limit would also appear difficult to enforce from a compliance standpoint.

If adopted, the proposed extension of the group insurance non-discrimination rules would cause employers, as a practical matter, to discontinue any meaningful level of death benefits for retired employees. The Treasury Department already has the ability to issue regulations defining group insurance under Section 79 and thus to eliminate perceived abuses in this area. We would particularly urge the Subcommittee not to make any change under Section 79 which would apply retroactively to benefits already in effect. The retroactive application of a change in the law to existing programs which have been established for retired employees could bring about severe (and we believe unintended) tax consequences in situations where the opportunity to change or revise the program may not necessarily exist.

8. Transition.—We believe the Subcommittee needs to concern itself with a number of transition issues which might well develop under the revised approach suggested by the Subcommittee. For example, existing investments may have deferred tax benefits which should properly be grandfathered for both stock and mutual life insurance companies so that companies do not lose tax benefits previously encouraged by Congress (e.g., loss carry-forwards, depreciation factors and the like). Provisions should also be made to allow companies which have previously filed consolidated returns to file on a separate return basis if, under the new law, the consolidation rules or effects change adversely.

The length of this submission does reflect genuine concern on our part with some of the specifics of the Subcommittee's proposal. Nevertheless, as indicated at the outset, we believe that the Subcommittee has begun to structure an approach which offers considerable promise, in our view, for arriving at a fair and equitable tax law applicable to life insurance companies in 1984 and beyond. We are as sincere in our plaudits for the Subcommittee's efforts as we are in expressing our concerns for some of the particular provisions which would adversley affect our Company and our policyholders.

We hope that our comments will be considered in the constructive light in which they are intended.

Respectfully submitted,

STUART G. SUMMERS,
Vice President and General Counsel.

STATEMENT OF PACIFIC MUTUAL LIFE INSURANCE CO.

The Life Insurance Income Tax Proposal published July 14, 1983, is an important first step toward developing a permanent structure in the taxation of life insurance companies. It has the potential for simplifying the law through the use of a single phase structure based on economic income with a minimum of special adjustments. However, the "return on equity" concept in the proposal, which would limit the deductibility of policyholder dividends by mutual companies as an "ownership differential," would violate this important purpose. By establishing what amounts to a two phase system for mutual companies, it would tax many of these companies on an imputed investment income which has no relationship to true economic income.

The following information showing the impact this proposal would have on Pacific Mutual indicates that it would impose an unfair and presumably unintended burden on that company and on other mutual companies in similar circumstances.

Because the proposal is in many respects conceptual only at this time, it has been necessary to make a number of interpretations, judgments and approximations in estimating the impact of such a law. With this qualification, the following estimates are believed to be fair representations of general magnitude.

PACIFIC MUTUAL'S FEDERAL INCOME TAX NET OF TAX CREDITS AND INCLUDING CAPITAL GAINS TAX

[In millions of dollars]

	1979	1980	1981	1982	1983	1984
Actual tax (per return)	15.2	10.9	10.0	0.5		
Estimated tax:						
1959 act (without Modco)		14.1	13.9			
TEFRA					8.3	10.6
1959 Act as amended				10.8		14.2
Subcommittee proposal	14.8	16.4	14.4	10.6	18.3	20.8
Subcommittee proposal if PM were a stock company	12.5	0	7.4	0.6	5.1	6.7

THE PROPOSED "RETURN ON EQUITY" VIOLATES THE CONCEPT OF TAXING ECONOMIC INCOME

In response to questions at the Subcommittee hearings on May 10 and 11, Walter Gerken mentioned that for the year 1980 Pacific Mutual paid income tax of more than $10 million in spite of the fact that the company's annual statement for that year reported a net loss from operations (after tax).

This was intended to illustrate one of the flaws and inequities of the 1959 Act.

The figures in the foregoing table show that, whereas the 1959 Act, with the benefit of a Modco reinsurance treaty produced a tax of $10.9 million for the year 1980, the current proposal would have developed a tax of $16.4 million. The problem in that year was a substantial loss from group health insurance operations which was not reflected in the Phase 1 limit on dividend deductibility nor in the proposed artificial "return on equity" limit. A stock company in similar circumstances would have paid no tax under the Subcommittee proposal.

In 1982 the company again suffered substantial losses from group health operations. The total tax reported under TEFRA was $0.5 million, appropriately reflecting this economic result. The estimated tax under the 1959 Act as amended by TEFRA would have been $10.8 million. The estimated tax under the Subcommittee proposal would have been nearly the same, $10.6 million. A similar stock company, on the other hand, would have developed only $0.6 million.

These two unfortunate but very real years demonstrate dramatically that the proposed limitation on dividend deductibility actually imposes a Phase 1-type of tax which has no relationship to economic income.

THE PROPOSAL WOULD IMPOSE AN UNCONSCIONABLE TAX INCREASE ON PACIFIC MUTUAL

In 1980 and 1981, two years for which estimates are available, the tax under the 1959 Act without recognition of Modco treaties would have been $14.1 and $13.9, respectively. Estimated tax under the current proposal would have been $16.4 and $14.4 million, substantially higher than under the old law which is recognized as being unfairly burdensome.

The estimated projected tax for 1984 is $14.2 million under the 1959 Act as amended but would be $20.8 million under the proposal, an increase of more than 46 percent.

Tax increases of this magnitude are surely not intended by the Subcommittee.

UNDER THE PROPOSAL PACIFIC MUTUAL WOULD PAY MORE THAN DOUBLE THE TAX ON A SIMILAR STOCK COMPANY

Over the six year period for which estimates were made of the impact of the Subcommittee's proposal, Pacific Mutual would develop taxes totaling $95.3 million whereas the total for a similar stock company would be only $32.3 million, just over one-third as much.

The estimated tax for 1984 alone on the mutual company basis is $20.8 million; on the stock basis, $6.7 million. The ratio is more than 3 to 1.

The estimated difference is based entirely on the "interest on equity" limitation. Surely no reasonable "ownership differential" would produce differences of this magnitude.

It seems clear that the Subcommittee does not intend to skew the competitive relationship between stock and mutual companies to this degree.

ANY "RETURN ON EQUITY" SHOULD NOT EXCEED A PORTION OF ECONOMIC INCOME

In the discussion of the ownership differential, the proposal states that the deduction for policyholder dividends would be limited so that "a company level tax would be levied on that portion of the company's income which represents the earnings generated by the policyholders' investment in the company."

This concept leads directly to the conclusion that any "company level tax" should be measured by the company's income. Moreover, the portion generated by the policyholders' investment in the company must be only a portion of that income. Assuming that the law will define the taxable economic income, the remaining problem is to define the appropriate portion of that income.

Starting with the total economic income before deduction of dividends to policyholders, the ratio of the "policyholders' investment in the company" (the "equity" as defined for this purpose) to the total assets of the company would provide a straightforward, easily understood basis for apportionment.

Such an apportionment of income before policyholder dividends would be related to economic income, would be based on each company's actual and unique circumstances, and would assure that a company with a positive income before dividends would always have a positive tax base.

ANY "OWNERSHIP DIFFERENTIAL" SHOULD NOT EXCEED THAT PORTION OF "RETURN ON EQUITY" WHICH IS RETURNED TO POLICYHOLDERS IN THE FORM OF DIVIDENDS

In a tax structure based on economic income in which dividends were 100 percent deductible, the portion of "return on equity" which would be distributed to policyholders and thereby removed from the tax base would be proportional to the ratio of dividends to economic income before deduction of dividends.

If this ratio were applied to the "return on equity" defined in the manner proposed in the preceding section, it can be demonstrated algebraically that the portion of the "return on equity" included in policyholder dividends could be calculated as the product of the dividends times the ratio, "policyholders' investment in the company" divided by the total assets of the company.

Such an "ownership differential" could be directly reflected as a reduction in the policyholder dividends deductible in the determination of taxable income for a mutual company.

CONCLUSION

The treatment of "ownership differential" in the Subcommittee's proposal is contrary to the intention of taxing economic income; would impose tremendous tax increases on mutual companies such as Pacific Mutual; and would introduce unintended and inequitable tax burdens on mutual companies as compared with stock companies, thus distorting competitive relationships.

These results are unnecessary since it is possible to introduce provisions for an "ownership differential" and limiting the deductibility of dividends which would be directly related to economic income, would be less onerous, and would be based on individual company characteristics.

APPENDIX TO PACIFIC MUTUAL TESTIMONY

I. Pacific Mutual has argued that any "return on equity" should not exceed a portion of economic income. It further proposed that the appropriate portion may be measured by the ratio of the "policyholders' investment in the company" (call this the "equity") to the total assets of the company.

If economic income for this purpose is defined as taxable gain from operations before deduction of dividends (G), equity is E and assets are A, this portion of economic income may be written as

$$\frac{E}{A} \times G$$

This obviously has the same value as

$$\frac{G}{A} \times E$$

The latter expression is easily seen to be a rate of return, $\frac{G}{A}$, times equity, where the rate of return is measured by the taxable gain before dividends in relation to the assets.

This follows the structure in the Stark/Moore proposal for defining a limit on dividend deductibility but uses a more meaningful and appropriate measure of the company's return which includes taxable income from all sources rather than an arbitrarily imputed investment rate.

Assuming this return on equity is to be used in defining a limit on deductibility of dividends, the originally proposed formulation

$$\frac{E}{A} \times G$$

is a useful form for its implementation for two reasons:

1. Since it is a positive fraction of gain before dividends, it will assure that dividends cannot reduce the tax base to zero.

2. It can conveniently be used to develop an aggregate average ratio for all mutual companies for the sake of simplicity and uniformity of application. The ratio or multiple of gain before dividends calculated in this way would probably be something less than 7%.

II. Pacific Mutual has further argued that any "ownership differential" taken into account in the tax base should not exceed the portion of return on equity returned to policyholders in the form of dividends.

If D represents dividends, that portion is the ratio

$$\frac{D}{G}$$

When this ratio is multiplied by the formula for return on equity, the result is:

$$\frac{D}{G} \times \left(\frac{E}{A} \times G \right) = D \times \frac{E}{A}$$

In other words, the ownership differential may be defined as a fraction of dividends. The fraction is the same one as was used in calculating the return on equity, the ratio of equity to assets.

This analysis provides a rationale for having both a minimum tax base and a differential for deductibility of dividends within the general structure of the Stark/Moore approach.

This particular formulation has the advantages that:

1. It provides an objective measure for defining a dividend differential
2. It accommodates the simplification of calculating an aggregate average ratio for all mutual companies, probably less than 7%.
3. It demonstrates that the several approaches suggested by different mutual company witnesses are not inherently inconsistent.

8/2/83

THE PENN MUTUAL LIFE INSURANCE CO.,
Philadelphia, Pa., May 9, 1983.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: The Penn Mutual Life Insurance Company, one of our country's major mutual life insurance companies located in Philadelphia, Pennsylvania, endorses the position of the mutual life insurance group as expressed in its written statements and testimony to the Subcommittee on Selected Revenue Measures except for the definition of life insurance proposed by such group.

Any definition of life insurance must address the legitimate concerns currently being raised with respect to certain products now being marketed by a few life insurance companies. On the other hand, such a definition (1) must not adversely impact on traditional life insurance products; (2) must be easily administered and understood by consumers; and (3) must permit and encourage life insurance companies to develop products designed to meet the needs of consumers under changing economic conditions. In Penn Mutual's opinion, the definition of life insurance being proposed by the mutual life insurance company group is too restrictive and thus fails to satisfy the above criteria.

For these reasons, Penn Mutual urges that the Subcommittee, in developing a definition of life insurance, begin with the present definition set forth in section 101(f) of the Internal Revenue Code. Such a definition satisfies the above requirements and has the additional advantage of being currently familiar to life insurers as well as consumers. Any abuses found in products now being marketed could easily be addressed by modifying the tests set forth in the section 101(f) definition.

Sincerely,

FRANK K. TARBOX,
Chairman and Chief Executive.

PROVIDENT LIFE & ACCIDENT INSURANCE CO.,
Chattanooga, Tenn., May 23, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures,
Committee on Ways and Means.

DEAR MR. STARK: I am President and Chief Executive Officer of Provident Life and Accident Insurance Company of Chattanooga, Tennessee. Provident is a stock life insurance company, which, in addition to issuing individual insurance contracts, is heavily involved in underwriting group life insurance and group accident and health insurance under employee welfare benefit plans.

Your Subcommittee recently held hearings on the taxation of life insurance companies. Although these hearings encompassed many of the important aspects of the life insurance business and how they relate to taxes, none of the witnesses stressed the special problems with the taxation of group insurance.

We believe that the unique character of group insurance requires that it be given special attention by your Subcommittee. This letter will discuss these special problems, and I request that it be entered into the record of your Subcommittee's hearings on the taxation of life insurance companies.

RECOMMENDATION

Our specific recommendation is that any legislation proposed by your Subcommittee, whether it is based on the 1959 Act, TEFRA, or a new approach, incorporate the principle that life insurance companies be allowed full income tax deductions for amounts paid or credited to policyholders of group life and group accident and health insurance policies. A full deduction for group benefits presently is not allowed by the Internal Revenue Service under current law.

Failure of the tax law to provide full deductions to life insurance companies for their costs of engaging in group business accelerated a trend away from insured employee welfare benefit plans to self-insured plans, and has placed life insurance companies at a competitive disadvantage vis-a-vis other providers of employee plans.

SOUND POLICY SUPPORTS FULL DEDUCTIBILITY OF GROUP BENEFITS

Unlike the situation with respect to individual insurance policies, amounts credited to the group insurance policyholders do not escape tax. The cost of group term life insurance and group accident and health insurance furnished by employers is a deductible cost by them. Amounts paid or credited by life insurance companies with respect to such group insurance reduce the deductible cost thereby increasing the employer's taxable income.

Rather than escaping tax, amounts credited to group policyholders under current law incur a double tax. They are taxed to the life insurance company by the denial of a deduction at the company level and are again taxed to the employer by reason of the reduction of his deductible cost.

No policy reasons under the 1959 Act, or TEFRA, or those underlying the "proxy tax" approach being considered by your Subcommittee require that life insurance companies be denied full deductions for the amounts paid or credited to group policyholders under insured employee welfare benefit plans.

CURRENT TAXATION OF GROUP INSURANCE

Group insurance contracts generally provide for a return to the policyholders of the portion of the premiums paid under the contracts which is in excess of the actual cost of providing group insurance coverage to their employees. The amounts to be refunded are determined and paid annually and are computed as the excess of the policyholder's premium payments for the policy year over claims, increases in reserves, expenses (such as premium taxes, commissions, and administrative expenses) and the insurance company's risk charge. The premium refunds are sometimes referred to as retrospective rate credits.

The Internal Revenue Service takes the position that under present law (the 1959 Act and TEFRA) retrospective rate credits are deductible only within the limitations for the deductibility of policyholder dividends provided by Section 809(f) of the Internal Revenue Code. Thus, in many instances, although the premium refunds constitute one of our major costs of writing group business, they are not fully deductible.

Group insurance contracts also frequently provide that the insurance company must credit interest to policyholder funds held under the contracts, such as claim reserves. As in the case of retrospective rate credits, the Internal Revenue Service does not permit a full deduction for this interest.

The effect of the failure of the tax laws to allow full deductions for group policyholder benefits is to increase the employer's cost of furnishing the employee benefits under insured plans. The result has been an increasing trend for employers to shift from insured plans to self-insurance or to tax-exempt providers. We are aware of no policy reason which supports this discrimination against insured plans offered by tax-paying life companies.

INSURED EMPLOYEE BENEFIT PLANS SHOULD BE ENCOURAGED

Employee group insurance offered by life insurance companies serves vital social goals for this country. Such insurance has enabled much of the public to be protected by life, health, accident, and disability insurance. Because of the large-scale administration of group insurance, it is usually less expensive than individual insurance and is often available to persons who would otherwise be uninsurable.

Group insurance provided by employers is often part of collective bargaining agreements between unions and employers. (In some instances lower employer costs in providing group insurance result in higher cash wages being provided to unionized employees in the overall compensation package.) Group coverage today is usually a normal part of a compensation package and often provides the only employee protection, besides governmental social welfare programs.

Despite the fact that the solvency of uninsured plans is typically more susceptible to economic declines than that of insured plans, there has been a significant trend away from insurance in favor of self-insurance. Insured plans, unlike uninsured plans, are subject to state regulation and are required to hold claim reserves to assure payment of covered claims. Many groups have unfavorable claim experience which puts the group into a deficit position. This has frequently been the case in recent years with group accident and health insurance. In this situation, the group insurer must then absorb the loss. If, because of the tax disadvantage imposed on insured plans, the employers had utilized a self-insurance approach instead of an insured plan this adverse claim experience could threaten the solvency of the employer, the security of payment for covered claims and the security of the jobs provided by the employer.

Since life insurance companies must maintain adequate claim reserves, the payment of covered claims is more secure under insured plans than under noninsured plans because the insurance company guarantees to make covered claim payments whether or not the employer has contributed sufficient funds to the employee benefit plan. With this security, it is clearly in the public interest to encourage insured plans by equating the tax treatment for group insurance provided by life insurance companies with that afforded other employee welfare benefits.

THE COMPETITIVE DISADVANTAGE OF LIFE INSURANCE COMPANIES SHOULD BE ELIMINATED

Although at Provident we endeavor to furnish group insurance to employee groups at the lowest possible cost, we are at a serious competitive disadvantage with other providers who are tax-exempt. The alternatives to group plans insured by life insurance companies include those provided by HMO's, Blue Cross/Blue Shield, and "self-insurance" through voluntary employee beneficiary associations (VEBA's) administered by banks and others. These alternative providers are tax-exempt under Section 501 of the Internal Revenue Code.

Because of this tax-exempt status, employee benefits provided by these alternative providers do not incur a tax cost. All amounts held under a tax-exempt plan, including any interest earned on plan contributions, are free of income tax. This enables these alternative providers to provide the employee benefits at a lower cost to employers than can life insurance companies.

Any revision of the law dealing with the taxation of life insurance companies should remove this competitive disadvantage by allowing life insurance companies full deductions for their group insurance costs.

SUMMARY

Insured plans should be encouraged. They provide the maximum protection for employers and their employees at a cost that is usually lower than individual insurance. Unlike self-insured plans, the spreading of the risks inherent in insurance and the insurer's maintenance of adequate reserves gives the greatest assurance that the promised employee benefits will actually be paid. This is particularly important for small employee groups which are most in need of risk spreading.

Fairness requires that life insurers be able to compete on an equal basis with their competitors. This requires a full deduction for amounts we pay to group policyholders. Because we do not receive a full deduction for such amounts under the current law, our tax on actual profits on our group business is in excess of that produced using the full corporate tax rate. We urge your Subcommittee to keep the principle of equality in mind when formulating legislation that will impact on group insurance.

Cordially,

H. CAREY HANLIN,
President and Chief Executive Officer.

SHENANDOAH LIFE INSURANCE CO.,
August 8, 1983.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: Shenandoah Life Insurance Company is a mutual life insurance company domiciled in Virginia and licensed in eighteen states and the District of Columbia. In comparison to some other companies, we are relatively small. At the end of 1982 we had assets of $254 million. Life insurance in force was $4.7 billion, $1.5 billion under individual policies and $3.2 billion under group policies. Premium income for 1982 was $52.5 million and investment income was $18.8 million.

We have reviewed Press Release No. 6 of July 14, 1983, from the Subcommittee on Select Revenue Measures. We are in agreement with the general approach to a single-phase tax system. However, at the Subcommittee's suggestion, we would like to share with you the way this proposed approach to life insurance company taxation would affect Shenandoah Life. We also will make some observations concerning the general structure of the proposal. In doing so, we hope that we will not duplicate opinions of the mutual company group with which we are in general agreement.

Our statutory gain from operations for 1982, after dividends to policyholders, was $1,560,000. Application of various income tax formulas to this gain would produce tax liabilities as follows:

Tax formula	*Tax liability*
Permanent provisions of 1959 act	$1,430,000
Stark/Moore	1,100,000
Stark/Moore as if we were a stock company	85,000
Stark/Moore without the minimum tax base or the 25-percent reduction	120,000

Several obvious conclusions can be drawn from these calculations.

1. The tax under the 1959 Act exceeds 90 percent of our pre-tax statutory income. This level of taxation is very punitive and unjust and confirms the fact that, for mutual companies, the 1959 Act is totally flawed.

2. The tax under Stark/Moore is 70 percent of our pre-tax income. Without the small company deduction, the tax would be 75 percent of pre-tax income. This also seems a bit confiscatory.

3. The difference under Stark/Moore between our taxes and those of a similar stock company is startling. This does not look quite like a level playing field.

4. If both the minimum tax base and the artificial 25 percent reduction were removed from Stark/Moore to produce a straightforward tax on operating gains, our tax would be low in relation to our earnings. If, however, the small company deduction were eliminated, our tax would be $330,000, 21 percent of our pre-tax earnings. This seems a reasonable level of taxation, and we see no need for special small company treatment.

Taxes under the Stark/Moore proposal would, at our present level of dividends and interest credits, leave us with no ability to increase our surplus on a reasonable basis. Our ratio of surplus to assets would systematically decline, eventually to unsafe levels, and our ability to grow would be seriously impaired. Conversely, if our dividend and interest credit structures were reduced to permit adequate surplus additions, we would be unable to compete in the marketplace, unable to grow, and, probably, unable to survive.

The primary reason the Stark/Moore proposal produces taxes of this magnitude is the minimum tax-base limitation. Our 1982 gain from operations before dividends is less than the "return on equity", and, therefore, none of our dividends are deductible. Our studies indicate that for the foreseeable future, we always would be taxed on the minimum base.

We have three difficulties with the minimum tax base.

First, we are not certain that our policyholders have any legal ownership rights in Shenandoah Life except in case of liquidation, and then only in the event the plan of distribution of assets so provides.

Second, our surplus is created by permanent assessments against earnings which might be distributed to policyholders. The after-tax earnings on these surplus funds are used to finance the growth and expansion of the Company and to provide part of the necessary growth in surplus to assure that our financial strength remains adequate. Although growth and financial soundness do benefit the policyholders in a general way, they cannot be attributed to policyholders in any specific way, certainly not in a way which makes them comparable to a stockholder's return on equity. While there may be years which are exceptional, in general our policyholders' dividends do not come from investment earnings on surplus.

Third, we are not aware that there is any precedent for a minimum tax base for corporations generally. If there is such a precedent, surely the minimum base should apply equally to stock companies.

The minimum tax base fails, it seems to us, for a mutual company which might sustain an operating loss. For instance, Shenandoah Life will experience extraordinary growth in sales during 1983. As a result of the heavy expenses necessary for this growth and for the expansion of our technical resources for future growth, we are projecting a pre-tax loss of $1,414,000 after dividends to policyholders. The Stark/Moore proposal would produce a tax liability of $92,000 in spite of this large loss. If we were taxed as a stock company on these results, we would have a tax-loss carry-forward of $1,100,000.

Practical considerations indicate that there will need to be some concession by mutual companies which recognizes the need for stock companies both to compete and to pay a reasonable return to their owners. Even so, we do object to the way the Stark/Moore proposal exacts this concession.

We prefer that the concession be determined by disallowing some reasonable proportion of dividends to policyholders. This approach would eliminate the necessity for the awkward and unusual use of a minimum tax base. We feel the 7½ percent differential used in the stopgap legislation is acceptable and equitable.

Assuming, however, that the concession will be determined as some rate of return, we would offer the following comments.

First, the only earnings accruing to policyholders from their "equity" in the company are the investment earnings on surplus. These investment earnings are measured accurately by our portfolio return on our assets. We feel that this rate of return is the one which should be used for mutual companies. If it is less than the typical stockholders' rate of return, it properly reflects the policyholders' risk is significantly lower than the risk of stockholders. Using our annual statement rate of return of 8.43 percent for 1982, this change in the Stark/Moore proposal would generate 1982 taxes for us of $510,000 on a statutory gain of $1,560,000. Without the small company allowance, the tax liability would be $652,000.

Second, we do take exception to the idea that a mutual company "rate of return" should somehow be tied to the results of other industries, and stock life insurance companies particularly, instead of to its own results.

A stated goal of the Stark/Moore proposal is a single-phase tax system. However, the proposed legislation will result in a three-phase tax law, depending on the relative magnitudes of a company's gain before dividends, return on equity, and dividend deduction. This is due to inclusion of the return-on-equity feature which is totally artificial and has no relationship to actual financial experience. Also, it generates the need for the 25 percent-of-gain deduction, another artificial feature included as the balancing item to produce the desired level of aggregate taxes. While we agree with the comment of one court concerning the 1959 Act, we are fearful that history may accord a similar description to this proposal due to the introduction of these artificial features.

We appreciate the opportunity to tell you how we are affected by the Stark/Moore proposal. We also appreciate the difficulty of the task before you. If we can provide additional information, we will be pleased to do so.

Sincerely,

WILLIAM R. BATTLE, *President.*

THE UNION CENTRAL LIFE INSURANCE CO.,
Cincinnati, July 26, 1983.

Re life insurance income tax proposal.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR SIR: The proposal for taxing life insurance companies, announced by Representative Stark on July 14, would probably cause our company, Union Central Life, to become insolvent within ten years if it were enacted in its present form. This would occur because the proposed tax base, the "return on equity floor," would exceed our gain from operations before dividends. This would:

1. Preclude deducting any of the dividends currently paid to our policyholders, implying that they are 100 percent a return on equity, a clearly inappropriate result;
2. Result in imputed "phantom" premiums, equal to the difference between guaranteed and actual premiums for indeterminate premium products, being added to our tax base with no offsetting deduction for the "phantom" dividends until the adjusted gain from operations before dividends exceeded the "return equity floor";
3. Treat the difference between actual interest credited and guaranteed interest (i.e., excess interest) as a non-deductible dividend;
4. Preclude the Company from receiving a tax benefit for initial losses incurred from establishing new products and/or new lines of business, yet tax the profits when they emerge; and
5. Preclude the deduction of losses on a non-dividend line of business, such as Group Accident and Health, yet tax the gains once the line returns to profitability.

We would not be able to shift this tax to existing policyholders, because premium rates are contractually established and reductions in established dividend scales would encourage them to surrender their policies.

We believe the rules established for limiting dividends and for classifying phantom premiums and excess interest as dividends are inappropriate for the following reasons:

1. Dividend scales on traditional insurance contracts are frequently established in order to avoid having to establish deficiency reserves. For example, we recently began to market a low-cost term product with a price structure which is illustrated by the following premium rates for a $100,000 policy issued to a male at age 40:

Policy year	Premium	Dividend	Net
1	$130	0	$130
2	170	0	170
3	210	0	210
4	230	0	230
5	358	$108	240
6	387	117	260
7	418	130	288
8	454	146	308

The premiums were artificially raised for the fifth and subsequent years and dividends were illustrated for these years in order to avoid having to establish non-deductible deficiency reserves.

2. Companies generally establish guaranteed premium rates for indeterminate premium policies equal to the maximum valuation premiums permitted by state valuation and nonforfeiture laws in order to prevent having to establish deficiency reserves, which are not deductible for federal income tax purposes. Accordingly, the standard used for measuring the amount of policyholder dividends is one effectively established by state insurance departments, rather than the company and its customers in a competitive selling situation.

Referring back to the example in 1, we chose to guarantee premiums for the first four years' and establish the resulting deficiency reserves. Alternatively, we could have made the first four years premiums indeterminate by staing a guaranteed maximum premium based on state valuation law. Nothing has changed, yet the proposal operates to create a "phantom" premium and dividend.

As another example, we began to market universal life in our mutual company on April 1, 1983. At that time, the State of Ohio had not amended its valuation and nonforfeiture laws to permit use of the 1980 CSO table. Accordingly, we were required to guarantee premiums based on the 1958 CSO mortality table in order to avoid having to establish deficiency reserves on this product. However, our actual premiums are less than the guaranteed rates because they are related to the 1980 CSO table which has been adopted by a majority of the states and reflects lower mortality rates than the 1958 CSO table. Further, it is our intention to not change these rates and we would be willing to guarantee these rates to customers if it were not for the deficiency reserve problem.

In both cases, the actual rates are the rates that we illustrated to our customers when we sold the policies and are the basis on which the contracts were sold. They are, in fact, the rates that we would be willing to guarantee if not faced with the deficiency reserve issue. We do not ever intend to charge the guaranteed rate, nor would our customers accept these rates if they were charged (i.e., raising the rates would probably cause our customers to surrender their policies). However, the proposed law would impute phantom premiums and dividends on these policies, even though the guaranteed premium scale has never actually been charged to customers.

3. The proposed law classifies excess interest as a policyholder dividend for federal income tax purposes, and it defines excess interest as the difference between the guaranteed interest rate and the actual interest rate. We believe the use of the guaranteed rate as the standard of measurement is inappropriate, because it is generally equal to the maximum rate permitted for reserve valuation purposes by state insurance laws. Again, non-deductible excess interest reserves would have to be established if higher rates were guaranteed.

This proposal would also require the use if a state mandated interest rate as the standard to be used in determining the amount of excess interest. In contrast, our universal life contracts are generally illustrated prior to sale on the basis of an 8 percent interest rate, not the 4.5 percent rate guaranteed in the contract. Further, the 8 percent rate is much more reflective of the rates we would be willing to guarantee for the first several years were it not for the conservative insurance law maximums.

4. The use of a return on equity standard for limiting the amount of policyholder dividends may adversely impact companies which market both dividend paying and non-dividend paying products, because it may prevent those companies from deducting all of the costs incurred in connection with the non-dividend paying products. The result is that the law as proposed is not product neutral, and it may prevent companies who now concentrate on the sale of individual life insurance from expanding into other lines of business marketed by life insurance companies.

For example, we significantly increased the sales of our individual disability income, individual retirement annuity and single premium deferred annuity products, which do not currently pay dividends, and of our group health products which paid limited dividends in 1982. The disability income, individual retirement annuity, and single premium deferred annuity lines generated losses as a result of initial start-up costs and the group health line generated losses as a result of adverse claims experience.

The example below shows how this would have affected us in 1982. Absent the non-dividend paying line losses, we would have been able to deduct $14,701,000 of dividends (out of $22,719,000) to reduce our tax base to the return on equity floor of $34,000,000. Bringing in losses of $15,020,000 only reduces our taxable income by $319,000 (the amounts in the table are in thousands of dollars):

	Combined	Adjustments	Dividend paying lines (primarily individual life)	Non-dividend paying lines
Taxable income (loss) before dividends	$33,681	0	$48,701	[1] ($15,020)
Dividends	0	$14,701	[2] (14,701)	0
Taxable income (loss)	33,681	14,701	[3] 34,000	(15,020)

[1] Includes group health dividends of $364.

[2] Total policyholder dividends amounted to $22,719

[3] Return on equity standard established by proposed law.

The use of a total company return on equity standard to limit the amount of policyholder dividends effectively eliminates the deduction for the start-up costs incurred in expanding into other lines of business, since the losses effectively reduced taxable income by only $319,000. However, as these lines become profitable, these profits will be fully taxed without benefit of a carryover of the prior losses. Looked at from another perspective, the dividend deduction is totally eliminated and losses are effectively converted into a return on equity to the individual life policyholder.

Is it reasonable for stock companies to be able to deduct such losses, but not mutual companies? Is it reasonable to impose on mutual companies, a return on equity that most stock insurance companies are not achieving? Should they not also be subject to some "return on equity floor"?

5. The proposal does not differentiate between pension and non-pension business. We believe that the TEFRA modifications should continue. Further, we do not believe it is appropriate to apply an ownership differential concept in order to limit pension dividends, because pension plans do not pay taxes on dividends earned on common stock owned by them.

6. Taxing stock subsidiaries of mutual companies as mutual companies and not providing for a 100 percent dividends received deduction for dividends paid by the subsidiary to the parent subjects the subsidiary's income to double taxation, because the subsidiary's policyholder dividend deduction would be limited by the ownership differential rules and dividend distributions to the parent company would also be partially taxed.

7. Under an economic gain approach, pro-ration of tax exempt interest doesn't make any sense at all. Banks are not required to pro-rate their tax-exempt interest between an Accountholder's Share and Company's share. To the extent it is being carried over into the new law, it is a vestige of the taxable investment income base under the 1959 Act.

Other life insurance companies will doubtless find defects in this proposal parallel to our analysis. Congressman Stark's draft is fatally flawed, and we hope that it will not be used as a working draft for future changes since many of the concepts are clearly unworkable.

Very truly yours,

STEPHEN R. HATCHER,
Senior Vice President.

JULY 26, 1983.

Hon. FORTNEY H. STARK,
House of Representatives, Longworth House Office Building, Washington, D.C.

Hon. HENSON MOORE,
House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN STARK AND CONGRESSMAN MOORE: We are writing to express our views about issues raised in the Select Revenue Measures Subcommittee pamphlet entitled "Descriptions of Life Insurance Income Tax Proposal." We have concerns with a number of the proposals including the definition of life insurance and the treatment of reserves. These concerns will be dealt with in the statement presented by the Stock Information Group. In addition, we are particularly disturbed by the proposals to change the rules with respect to the treatment of annuities.

The three revisions you have proposed (which we understand are not intended as direct revenue measures) would provide additional limitations and restrictions on annuity policyholders. These would include: (1) mandatory annuitization at age 70½; (2) extension of the penalty tax to distributions prior to age 59½ through the elimination of the "10 year rule"; and (3) extension of the payment period for the waiving of the penalty tax from 5 years to 10 years.

As you know, TEFRA contained certain provisions regarding insurance, some of which were permanent and some of which expire on December 31, 1983. The changes regarding the tax treatment of annuity contracts at the policyholder level were permanent and involved: (1) the reversal of the order of withdrawals from an annuity contract so that currently taxable income was withdrawn first and then followed by principal, and (2) the imposition of a 5 percent penalty tax on withdrawals prior to the earlier of 10 years or 59½.

These revisions, which substantially changed the taxation of annuity contracts, were made to guarantee the use of an annuity contract as a long term retirement and savings vehicle and to prevent perceived abuses regarding the use of an annuity contract as a short term investment vehicle. In addition, tax compliance on annuity contracts was also strengthened through the TEFRA withholding provisions. Beginning July 1, 1983 a certain portion of payments to policyholders is now being withheld.

The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, stated on March 1, 1983 before the Association of Advanced Life Underwriting that with respect to annuity contracts, no further tax restrictions are necessary. With respect to the change in the taxing of withdrawals and the penalty tax for early distribution brought about by TEFRA, Mr. Chapoton stated as follows:

"The net effect of these changes is to preserve the benefit of the deferral of tax on earnings through an annuity for traditional deferred annuity contracts, while denying much of this benefit where an annuity is used as a short-term investment vehicle. We think that this is a satisfactory solution and we have no plans to seek any further changes in the tax treatment of annuities."

Mr. Chapoton's written statement and oral presentation before your Subcommittee was consistent with the quoted statement as he did not propose any changes in the tax treatment of annuity contracts.

You have indicated in your proposals that the change in annuity rules is being advanced to make the annuity contract generally conform with the provisions applicable to individual retirement accounts. There is, however, a major distinction between an annuity contract and an individual retirement account. A premium payment to an annuity contract is made with after tax dollars. A payment to an individual retirement account is made with pre tax dollars. This is a major distinction which should not be forgotten or disregarded by your Subcommittee. It must also be remembered that an annuity contract is not a tax avoidance vehicle, as income will be realized to the extend of the tax deferred accumulation on any distribution. Lack of thorough understanding of this distinction may have led to what we consider a troublesome recommendation in the July 14 proposal.

In addition, these proposed revisions are inconsistent with the government's avowed intention of encouraging, not discouraging, savings for long term retirement needs. The proposed restrictions discourage savings in a product substantially revised by TEFRA to correct any perceived abuses. The annuity contract must now be used as a long term retirement and savings vehicle, but it must be allowed flexibility in use. A person's financial situation or needs 10 or 20 years hence cannot be predicted accurately. Individual goals may be different. Changes in circumstances may occur which were not foreseen at the time that a premium payment was made. With the increase in longevity, and the current trend to extend the retirement age, individuals will continue to work beyond 65 or 70 and may not desire to begin receiving annuity benefits at 70½. Circumstances change, a younger policyholder may need to use funds accumulated under an annuity contract for a different but entirely legitimate purpose such as college for a son or daughter. Such withdrawals are already discouraged because they would be subject to a withdrawal charge under the contract. The penalty tax assessed against a younger annuity policyholder would be counter-productive and undoubtedly would result in the annuity contract being no longer competitive particularly when the withdrawal charge is factored in.

During the assimilation period following TEFRA our annuity sales were reduced. It took a period of time following TEFRA before our distribution sources felt comfortable again in selling annuity contracts. To impose another period of uncertainty with respect to taxation of annuity contracts would constitute, we submit, a disservice to the public which buys these socially desirable contracts and the companies which sell them.

Sincerely,

DANIEL J. BURNS,
Chief Executive Office, United Companies Insurance Co.
THOMAS R. ANDERSON,
Chairman and CEO, Kemper Investors Life Insurance Co.

MEMORANDUM

This memorandum discusses issues concerning the tax treatment of annuities raised in the Select Revenue Measures Subcommittee pamphlet entitled "Description of Life Insurance Income Tax Proposal."

In the last Congress, as you know, many issues relating to the tax treatment of insurance companies were left unresolved by Stop Gap. This is not true of annuities, however, TEFRA provided that partial surrenders or cash withdrawals prior to the annuity starting date are income to the extent that the cash value of the contract exceeds the taxpayer's premium payment. Policyholder dividends and loans against an annuity contract are also treated as taxable withdrawals. In addition, the Act imposed a 5 percent penalty on early withdrawals from an annuity contract. These changes eliminated whatever abuses were thought to exist with regard to annuities and insured use of these contracts as a long term retirement and savings vehicle.

There are a number of differences in the Federal tax rules which apply to tax qualified corporate and H.R. 10 plans, IRA's and annuities. Most of these differences in treatment favor the tax-qualified plan. For example, the most important difference by far is that contributions to H.R. 10 plans and IRA's are tax deductible for Federal tax purposes. A premium payment to an annuity contract is not. Loans based upon an annuity contract are treated as taxable distributions. Loans from an H.R. 10 plan (other than to owner/employees) are permittted without adverse tax consequences up to certain limits. Also, there is an $100,000 estate tax exclusion for certain benefits paid under H.R. 10 plans, IRA's and qualified corporate plans. No such exclusion exists with respect to nonqualified annuity contracts.

Distributions from qualified plans and IRA's must begin in the year in which the participant attains age 70½ or, (except for key employees) in the year in which the participant retires, if that is later. If the individual remains in employment, however, he may continue to participate in a qualified plan, but not an IRA. Payments must be made at least ratably over the life of the participant, or the lives of the participant and his spouse. Amounts payable after the death of the participant to a beneficiary other than his spouse must generally be made over a 5-year period, or less. No such restrictions apply in the case of an annuity contract.

These differences in treatment are justified by the different purposes served by tax qualified plans and nonqualified annuities. For those who purchase a contract which begins annuitization after age 70½, that contract can be an extremely important part of their financial planning. Such contracts provide emotional security because the owner knows that he or she cannot outlive the income. The purchase of annuity contracts may relieve a recently widowed spouse from the need to undertake responsibilities for managing investments. Circumstances change for people as they get older, and in some cases an individual who does not need the security of regular monthly income at age 65 may want such protection later in life.

An arbitrary cut off point of age 70½ is particularly inappropriate because of the trend in this country for people to work longer and retire at a later age. The recent Social Security legislation, for example, gradually increases the normal retirement age for purposes of Social Security from age 65 to age 67.

The age 70½ is necessary in the case of a qualified plan to ensure that the plan assets, built through tax deductible contributions, are used for retirement purposes. Moreover, the age 70½ rule limits the period of deferral for tax free earnings in a qualified plan. Further, there is an $100,000 estate tax exclusion for certain benefits from qualified plans.

These considerations do not apply in the case of nonqualified annuities. The amount used to purchase the contract is not tax deductible. There is no deferral of tax on the earnings from an annuity contract until the contract is purchased. There is no more deferral on an annuity contract purchased at age 75 than on a similar contract purchased at any younger age. (In fact, there is less deferral, since life expectancy is shorter.) Accumulating assets in nonqualifed annuities cannot be used to avoid estate taxes because there is no estate tax exclusion for such annuities.

Distributions from qualified plans or from IRA's are subject to a 10 percent penalty if these distributions occur before the participant attains age 59½. Distributions from an annuity contract are subject to a 5 percent penalty unless the contract has been held for at least 10 years (or unless the annuitant has attained age 59½).

These rules should not be disturbed. Congress enacted the 5 percent penalty for premature withdrawal from an annuity contract as part of the 1982 Act and there is no reason at this point to assume that a 5 percent penalty is not adequate. The 10 year rule on premature withdrawals is sufficiently rigorous to ensure that annuity contracts are being used for long term savings. Unlike amounts contributed to qualified plans, annuity contracts are not purchased with tax deductible dollars. Moreover, while participants may borrow limited amounts from qualified plans, loans from annuity contracts are generally treated as taxable distributions. Thus, the relatively minor differences in the tratment of premature distributions from qualified plans and IRA's, as opposed to annuity contracts, are easily justified.

Under TEFRA, the penalty for early distribution was not applicable if the distribution was annuitized over a five year period. The Subcommittee proposal would change this to a ten year period. We feel that the increase is not warranted. A five year requirement is sufficient to insure that the annuity is being used as a vehicle for long-term savings. A ten year requirement deprives the annuity contract of needed flexibility to accommodate changed circumstances, or to meet certain family needs, such as providing for a college education.

In summary, annuities today are fulfilling an important need for a substantial group of the elderly who wish to have the type of security which a life annuity contract can provide. The changes made by Congress last year are sufficient to control any abuses which may previously have existed. There is no need for further revisions of the law in this area.